PEI Research Department

The Rise & Fall of the Consumer Price Index

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It is often said that beauty lies in the eye of the beholder. Oddly enough, the same can be said of inflation. You will undoubtedly read headlines that state that inflation is under control. You will also read of analysts who continue to project lower interest rates long-term based upon their assumption that real interest rates (interest rates - inflation) are historically high. The big question, which arises from a forecasting perspective, is what does the future hold?

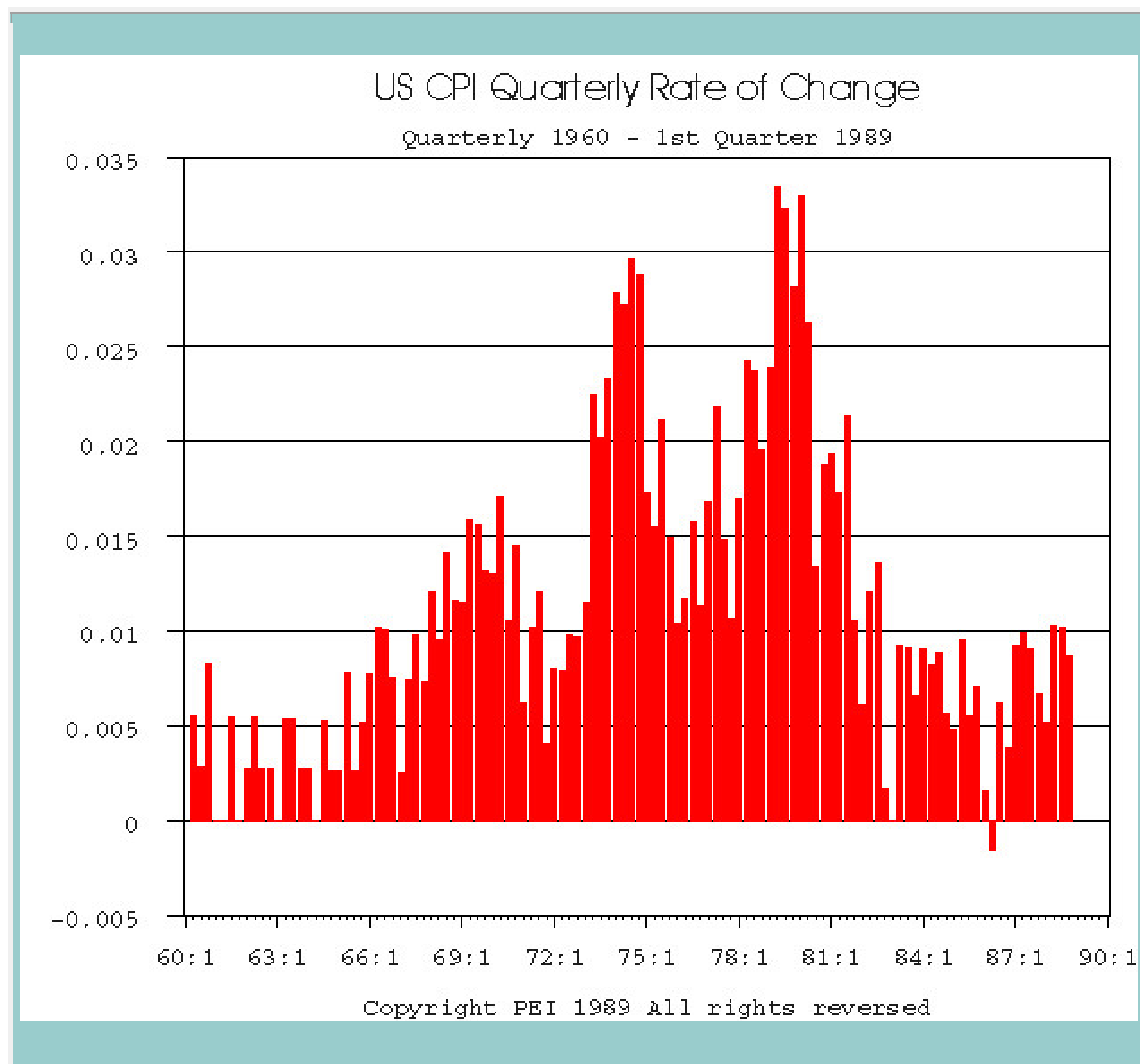
You will find effectively two camps - the deflationists and inflationists. It is important to that inflation is under control. What if the assumption of inflation being under control is wrong? If this view is determined relative to the CPI, should we merely accept the CPI without understanding its component structure?

It is widely known that our model successfully pinpointed the long-term change in trend from deflation to inflation back in July 1985. Among our most loyal long-term clients, it is widely understood that the Consumer Price Index is anything but a definitive representation of inflation. Nonetheless, although we have been highly critical of the CPI index insofar as its relative validity in terms of tracking inflation, we have dealt with this topic in-depth at our conferences, seminars and in special reports. Therefore, perhaps it is time that we address the background of the CPI in a little more detail within this report. I hope that this will provide a glimpse at some of the collateral material that forms an integral component of our model development at Princeton in regard to inflation.

The rise and fall of the CPI is certainly not a headline grabber as it was during the late 1960's and throughout the 1970's. The 1980's has been a era of deflation to some degree and the consequences of that trend have led to more confusion than enlightenment when it comes down to the topic of inflation.

We have discussed on numerous occasions that inflation is anything but one-dimensional. The 60's was a period known as the "wage-price" spiral because wages rose out of the shortage in skilled labor. The 70's were known as the "price-wage" spiral because shortages in commodities and hoarding contributed to rising prices while labor

fought for CPI increases. The period of 1980-1985 should have been inflationary under the classical theory that inflation is "too much money chasing too few goods." However, even though the national debt of the U.S. doubled the money supply rose faster than a hot-air balloon. Oddly enough, inflation declined when it should have risen because increases in government expenditures were merely offset by the decrease in private expenditures. Clearly, inflation is multi-dimensional which derives its source from a variety of stimuli.



Still we find the deflationists arguing for something they do not truly comprehend while attempting to backup their forecasts based upon CPI statistics. Unfortunately, their dependency upon the CPI to support their theories of why inflation is dead is actually living proof as to why they are dead wrong. In this regard, it is the component structure

of the CPI, which is the best evidence as to why inflation is rising significantly in real terms setting the tone for an advance in commodities themselves of a sustained nature.

There is one saying which former President Reagan has made numerous times in explaining the U.S. and Soviet relations - "trust, but verify." That is also our general philosophy at Princeton in regard to government statistics - trust, but verify. In those three words lies a lot of truth. Insofar as its relevance to the CPI, it simply means that we must verify all statistics and not just accept them as the gospel truth.

The CPI has several major problems. The most noted is that which deals with real estate. The housing component is 39% of the total CPI. A major revision has taken place in 1983 whereby real estate has been largely replaced by rents. In theory, a house is an investment - not an integral part of our cost of living. Therefore, real estate is the investment while rents are more indicative of the cost in housing.

Problem number one is philosophically that this is a poor attitude when facing the needs of young couples. Besides that factor, rents are controlled in many areas including New York City for that matter. Therefore, rents do not necessarily offer a clean free market indication of price trends on a national basis.

Problem number two arises from the source of the data from which this 39% housing component derives its statistical foundation. The source is the Federal Housing Administration (FHA) which imposes a maximum limitation of $60,000 on a home. This means that the housing component is essentially capped at $60,000. This may be fair for inner-city sections that are run down or in the depressed oil regions of the South; however, this is far from realistic when considering the regions containing the greatest population density ratios.

The problems arising from the housing component within the CPI are obviously important given the 39% structure. However, we must also understand that sizable incentives exist within government to water down the CPI as much as possible. Consider that most contracts are based upon some CPI clause be it rents commercially or wage negotiations both private and public. Social Security and other entitlement programs are also tied directly to CPI increases. Therefore, if the CPI can be made to "appear" to be rising slower that reality, the net effect is a means of cutting Social Security without have to officially announce that cuts are being made.

The problems with the CPI do not stop there. Additional faults within the formulas exist in both quality and appearance. This has contributed greatly to the long-term effect of creating a larger differential between reality and the myth.

The "appearance" consideration within the CPI is an important issue. Items, which are deemed appearance enhancements, are ignored regardless of their impact upon price. For example, let us say that an automobile is constructed with leather seats. As the cost of production rises, those seats are replaced with vinyl. When the cost of production rises further, the seats are replaced with a very cheap cloth. Had the car been produced

with leather seats and those costs passed on, then the CPI would reflect a rise. But since such changes would be regarded as "appearance" and the cars still possess a seat, if such replacements enable the retail price to remain unchanged, the CPI would NOT reflect a rise because the change was only in "appearance."

This "appearance" aspect of the CPI is important over the long-term. For example, a house built 30 years ago had plaster walls. Today such construction would cost at least 3 times the amount of drywall. Housing costs are measured by the square foot without regard to the changes in appearance. This seriously affects the actual inflationary trends over the long-term by dramatically reducing the actual "true" rise in a standard value of consumer products.

Another problem which is of major concern is that of "quality" considerations. For example, when auto pollution devices were mandated by law, those costs were bore by the consumer. The average cost rose sharply adding a few hundred dollars to the price of automobiles. That was deeded to be added "quality" and therefore was ignored by the CPI. By law, if all cars were mandated to have a satellite tracking system and a mobile telephone, and if such devices doubled the cost of automobiles to the consumer, the CPI would reflect no change because the consumer would be receiving a new device which he had not received before and therefore it is not inflationary.

The CPI also ignored taxation, which is the cost of government, with the exception of some real estate taxes. But if income taxes were doubled, which means that the cost of government to the consumer has doubled, taxation would be deemed to be a necessary cost of everyone's living and therefore would not be included.

The lists of problems are infinite, but you can see that the CPI is far from a realistic indicator of true inflation. The government itself makes no claim in its documentation as to the validity of the CPI in reflecting the average rise in consumer prices. In regard to using the FHA data, which effectively places a cap of $60,000 on housing considered in the CPI, they argue that the consistency of the data provided by the FHA justifies its use even though it may not be indicative of a large segment of the marketplace.

Therefore, the next time you hear someone say that inflation is dead, you will be able to speak on this topic with some authority. Inflation is far from dead and the only dead thing around is the brains of those who are try to deliver its eulogy.

When Secretary of the Treasury, Mr. Baker, stated that monetary policy should be guided by using a basket of currencies, most listened but they did not understand. What he could not say publicly was that the CPI is worthless as a tool to gauge monetary policy. Commodities or the raw data without fancy formulae, seasonal or political adjustments are the true means by which we should view inflationary trends.

When the Chairman of the Fed raised the discount rate in August of 1987, the press asked him why. He replied quite honestly - he saw a rise in inflation. Strangely enough - nobody listened. Again in August 1988 the Fed raised the discount rate and again the

reply to questions was a simple statement - inflation is rising. Most thought this new Fed Chairman was inexperienced. Why was he concerned about inflation when deflation existed? Obviously, the CPI gains were marginal at best running under 5% annually. Was he being overly concerned with inflation?

The answers were perhaps too simple for most to understand. Unless the Treasury and/or the Fed directly states that the CPI is not indicative of true inflationary trends, the majority will still be looking for lower interest rates, declining commodities and rising bond markets. Consequently, the old adage comes to mind - "a little bit of knowledge is dangerous." Indeed, we all know that the CPI is the Consumer Price Index, which reflects the overall inflation rate. What we do not know is how it is calculated. Hence, a little knowledge is indeed dangerous. While the majority still expects lower inflation based upon the CPI, the trends within the free markets go about their business making fools out of theory. It is not so much that theory is breaking down in economics as much as the statistics upon which such theory is based leave a lot to be desired.

So, when we say that inflation is rising and will continue to do so in 1989, do not judge us by the CPI - judge us by the actions of the marketplace. The CPI will still rise in 1989, but nowhere near as much had it included the cost of government, prices advances due to appearance, changes in real quality and a lifting of the $60,000 cap in housing data. If those things were included, we would all see that the CPI is currently advancing at nearly 10% annually instead of the official version of 4.5%.