Why inflation is lower than you think

Robert Huebscher | Advisor Perspectives| 11 November 2015

Financial pundits routinely claim that US inflation is much higher than the reported statistics. We hear, for example, that food prices have risen much faster than the roughly 1.5% increase in the consumer price index (CPI) over the past several years. Viewed over the longer term, however, US inflation is far lower than reflected in the published data.

The reason for this anomaly is that the CPI doesn't reflect the rapid advances in technology and the new products and services that have benefited everyone. The implications are profound. For example, real GDP growth is greater than has been reported, and some claims of income inequality are misleading.

This theme was the focus of two recent presentations I attended. On 18 October, economist Dr Woody Brock hosted a private gathering of investment professionals from Australia and New Zealand, organised by the PortfolioConstruction Forum, at his home in Gloucester, Massachusetts. On 22 October, Rick Rieder, CIO of fundamental fixed income at BlackRock, spoke at the CFA Institute Fixed Income Conference in Boston.

Let's look at the distortions in the reported inflation statistics and the implications they have for policymakers.

THE PROBLEMS WITH THE CPI AND PCE

The CPI, which is administered by the US Bureau of Labor and Statistics (BLS), and the personal consumption expenditure (PCE) index, which is the Fed's preferred metric for measuring inflation, rely on tracking the prices of a basket of consumer goods. Those goods include food, clothing, energy and housing, which is the largest component of both indices.

They differ in that the CPI maintains mostly fixed weightings, whereas weightings in the PCE are adjusted over time. The PCE also incorporates "chained weighting" adjustments – it assumes, for example, that if the price of beef increases rapidly, then consumers will adjust their tastes and purchase less. As a result of the difference in weightings, over time the PCE typically reports lower inflation than the CPI.

But the problem is that the hedonic adjustments do not fully reflect advances in technology.

As Brock said, the published inflation data "seriously overstates inflation."

Technology advances are apparent in the quality of televisions, which has improved vastly over the past 50 years. Compare the small black-and-white TV sets of the 1960s to today's

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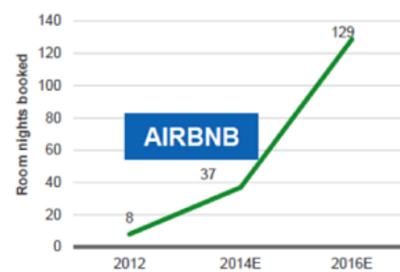
60-inch high definition flat-screen pictures. As Brock noted, the typical lifespan of light bulbs has increased from four months to nearly 20 years over the last couple of decades. Our chance of surviving a motor vehicle accident is five-times greater since the introduction of seatbelts and airbags.

None of those advances are fully reflected in the CPI or PCE. Nor are the advent of new services, like Uber and AirBnB, which have greatly reduced the costs of travel and accommodations. Rieder provided the graph below that illustrates their adoption rates:

Number of new driver-partners starting each month in the US

Source: BlackRock

...Airbnb rooms for lease could ize within 12 months



Source: BlackRock

According to Rieder, the adoption rate of this new app-based technology has been among the fastest in history, accompanied by broad-based implementation. Indeed, its rate of adoption has been rivaled only by that of automobiles.

Pundits frequently offer claims that the price of food has risen faster than the CPI or PCE indicates. But, as Brock said, that neglects to incorporate improvements in the quality of food available to consumers. "It used to be," he said, "that going out to eat meant spaghetti and meatballs or MSG-laden chicken chop suey." Now, he said, restaurant diners can choose from cuisines such as Thai, Lebanese, Japanese and Brazilian.

Unfortunately, no metric accurately reflects what the rate of inflation would be if it properly included these advances in technology and the resulting improvement in our standard of living. Those benefits are particularly true for Americans, since the strength of the dollar, due to its reserve-currency status, allows US consumers to purchase cheap imports – like those flat-screen TVs that are manufactured in Asia.

IMPLICATIONS FOR POLICY MAKERS

The mismeasurement of inflation has clear implications for monetary policy. The Fed has an arbitrary target of 2% inflation. But if neither the CPI nor PCE accurately measure inflation, than that target is even more arbitrary. To the extent that underlying inflation is lower that

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the reported data (and that the reported data may eventually reflect lower inflation), it will be even harder for the Fed to achieve its target.

It also casts doubt on whether the Fed should rely on the Phillips Curve, which measures the relationship between inflation and unemployment.

Another implication is that real GDP growth, which is nominal GDP growth minus the rate of inflation, has been greater than what has been reported.

Likewise, as Brock noted, productivity growth has been stronger than what has been reported. Productivity growth is the percentage growth in real GDP minus the percentage growth in hours worked. The latter term is known and accurately measured, so productivity growth is understated to the same degree as real GDP growth.

Implications extend to the debate over income inequality, which was triggered by the publication of Thomas Piketty's book, Capital in the Twenty-First Century. One aspect of that debate has been the claim that the standard of living has decreased for the non-wealthy.

According to Brock, that claim is false.

The correct way to measure the increase in standard of living, he said, is to ask consumers how much of their income today they would be willing to give up to be indifferent between their standard of living and what it was 30 years ago. If that amount is greater than zero then the standard of living is increasing, even for the poorest Americans. He said that living standards, measured this way, have gone up at least 40% over the last 30 years, due largely to the improvement in the quality of goods and services.

Brock also cited the work of Martin Feldstein, a professor at Harvard, whose research has shown that if one includes the growth in the capitalised value of entitlement programs (such as Medicare and Social Security) over the past 40 years, then there has been no growth in the wealth gap between the top and bottom 50% of the workforce.

Looking beyond the pervasive flaws in the inflation and related data, Brock was pessimistic about the prospects for growth in the US economy. As has been noted previously in this publication, he is an outspoken advocate for infrastructure spending focused on high-rate-of-return projects. Indeed, regardless of how inflation is measured, he said monetary policy alone would not stimulate growth. Unless accompanied by structural reforms and pro-growth fiscal policies, he said the US will face "chosen stagnation" and not the "secular stagnation" that Larry Summers portends.

Unfortunately, he said, we live in an "age of populism." Politicians have a hard job because they are dealing with voters who have been indoctrinated to hate deficits. "The public," Brock said, "is being fed a diet of lies."

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Brock put probability of the adoption of “good policies” at 15% to 20%. "So we will have slow growth," he concluded.

Robert Huebscher is the Founder and CEO of Advisor Perspectives. Bob founded Advisor Perspectives in 2007, following a 25-year career in the financial services and information technology industry. This article is abridged and reproduced with permission from Advisor Perspectives.

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