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Can We Use the CPI to Conclude that We Have No Inflation?

Unless you have closed your eyes and ears to radio and TV commentators for the past six months, you are aware that most of them are pooh-pooing the likelihood of US inflation anytime soon. This conclusion seems to ignore the contrary evidence. There have been dramatic rises in the price of gold, copper and famous-painter art, to name a few channels in which the Big Money Players typically bet on inflation. Commentators typically point to unemployment above 10%, plus a larger number of under-employed, topped by a housing market with huge inventories and banks that won't lend out their TARP money. All of that, they say, will force the Federal Reserve to keep stimulating. Maybe so but, we think, simplistic.

The US Consumer Price Index (CPI) is the most used yardstick for measuring domestic "inflation". It represents a vast, continuous nationwide survey of 80,000 items of goods and services prices which, after much high math, arrives at an index of consumption-spending by the average US consumer. The CPI's influence upon the US economy is deeply significant; but, according to the government agency that produces it, *the CPI is NOT a "cost of living index"*. Moreover, it is at best a significantly trailing indicator of what it does measure. Despite its influence in the economy, the Index's components and, more particularly, their weightings are not widely known or chattered about on cable TV, for good reason. The elements currently are:

1. Housing (43% weighting)
2. Transportation (15%)
3. Food & beverage (16%)
4. Medical care (7%)
5. Apparel, recreation, education and other goods and services (19%)

Buried in the above figures are weightings totaling 22% for:

1. Energy (7.6%)
2. Food (14.6%)

These two, deemed to be "non-core" elements, are subtracted from the so-called "headline inflation" figure, in order to arrive at "core" inflation, a result which causes quarrel from almost everyone who is not a statistician.

Observation: It is immediately apparent that, if the cost of "housing" is stable or declining, then changes in the overall CPI will almost surely be very low or negative. So, what is included in housing? Rent and utilities, of course, but what about owner-occupied housing? The calculation is inscrutably complex, but more or less, it's a change-measurement of "rental equivalent costs", i.e., changes in household outlays for property taxes, utilities, maintenance, insurance and debt service. The Index also includes a measurement designed to capture the change in home market values.

Observation: The CPI contains a considerable number of anomalies; for example: the "medical care" measurement reflects consumers' out of pocket cash. So, because employer-provided insurance pays the bulk of US medical care bills, the CPI does not, by far, capture the actual rising cost of medical care in the US economy.

Conclusion: The US's Consumer Price Index is an after-the-fact indicator of changes in an average resident's living expenses. The CPI's heavy Housing component (especially "core" CPI) will likely cause it to look anemic in coming months and years. *But the CPI is not intended, and should not be used to measure the purchasing-power trend of the US dollar, both at home and abroad.* There are several situations that can cause significant upward pressure on US domestic price inflation; they are:

1. When US imports significantly exceed exports and the importers pay their foreign suppliers with US dollars that are declining in value versus other currencies, prices of those imports inflate.

2. When the supply of dollars in the US economy is expanding strongly (a result of US Treasury debt creation and/or Federal Reserve money-printing), the prices of things measured in dollars inflate.
3. When worldwide demand for key commodities is rising strongly, their prices inflate. Example: Unless demand for oil is also falling when the dollar is falling, then the natural \$price per barrel must rise. In fact, prices of all other US imports will generally increase as a result of a falling dollar.

All three of the above are now in play.

There are two more major traditional inflation-causing scenarios which are NOT now in play....these are the ones that so many radio/TV commentators (correctly) cannot envision anytime soon, causing them to conclude (incorrectly) that no inflation is either with us or in prospect:

4. When worldwide demand for a US product/service tops about 80% of that source's US production capacity, its price inflates.....Not happening now; not likely to happen soon.
5. When goods and services production cost rises, due to:
 - a. Pay increases and/or
 - b. Raw materials cost increases,
 - c. *Unless* there are offsetting productivity gains,
 their prices inflate...Not happening now, or soon, for all the reasons being focused upon by dozens of TV pundits.

The White Knight may (this time) be riding an exhausted horse

In the modern past, e.g., the 1980s, potentially disastrous US fiscal/monetary policy and a weakening dollar has been rescued by foreign direct investment in US Treasury debt, commercial property and manufacturing plants. We entered the 1980s with attractive, double-digit US Treasury interest yields, created by the Federal Reserve in order to tame then-rampant consumer price inflation. But, in stark contrast, we now have zero-percent short term US Treasury yields that have transformed traditional renting out of money into little more than free parking.

Any foreigner who lends to Uncle Sam now literally has either no return, and no hope of any, or has a losing investment, when measured in his

home currency. Example: a German investor who committed €100,000 to UST-bills in early March 2009 lost almost 20% in only 9 months. On the other hand, The Peoples Bank of China (BOC) has experienced no such loss on its hundreds of billions of UST-bills, because the Bank has artificially "pegged" its currency at 6.83 yuan to the dollar*. Can this continue indefinitely? We shall see. It is easier to envision the BOC quietly diversifying some portion of its dollar-mountain of investments into other currencies and, perhaps, gold. But the BOC is somewhat stuck with the comely US lassie it brought to the party, even though, as if in some B-grade horror film, she transformed herself to a hag. Any drastic abandonment of the US dollar by China will cause it to experience horrific losses, amid the market volatility that would surely ensue.

*Unlike other major currencies, there is no free trading market for the Chinese yuan; the dollar value of the yuan is fixed by the Peoples Bank of China; the bank has not changed the dollar/yuan exchange rate for about 5 years. So, as the dollar declines against the Euro, the Yen and others, so does the yuan, even though the Chinese economy is growing faster than almost any other on the planet. The result: China is an export-dependent economy; a cheapening yuan means that most foreigners (other than US) are buying China-produced goods at declining prices.