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The CPI: Widespread Misuse and Consequences

Unless you have closed your 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, notwithstanding the dramatic rise in the price of gold, copper and famous-painter art, to name a few channels in which the Big Money Players typically hedge against inflation. Commentators typically point to unemployment above 10%, plus a larger number of under-employeds, 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 consider those commentaries to be generally simplistic.

As we all know, the Consumer Price Index (CPI) is the most used yardstick for measuring "inflation". It represents a vast, continuous nationwide survey of 80,000 items of goods and services prices; after much high math, this survey produces an index of consumption-spending by the "average" US consumer. The CPI's own 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"*. Instead it is, at best a significantly trailing indicator of what it measures. Despite its economic influence, the Index's components, especially their weightings, are not widely known or chattered about on cable TV. 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 sifted 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 CPI will be low, even if retail prices are rising moderately. So, what is included in "housing"? Rent and utilities, of course, but what about owner-occupied housing? The calculation is inscrutably complex; more or less, it's a change-measurement of "rental equivalent costs". So, what's that? Its 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 and Medicare pay the bulk of US medical 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 robust 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:

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: One key US import is oil; without regard to supply/demand factors, oil will rise in \$price to offset the amount of decline in value of the US dollar. So, when the dollar is falling, the natural \$price per barrel of oil 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 rising anytime soon, causing them to conclude (incorrectly) that there is no inflation on the horizon:

4. When worldwide demand for a US product/service tops about 80% of its provider's US production capacity, the price inflates.....Not happening now; not going to happen soon.
5. When goods and services production costs rise, due to:
 - a. Pay increases and/or
 - b. Raw materials cost increases,
 - c. *Unless* there are offsetting productivity gains,
 then, their prices inflate...Not happening now, or soon.

The White Knight is riding an exhausted horse
In the modern past (e.g., the 1980s), potentially disastrous US fiscal/monetary policy and weakening dollar has been rescued by foreign direct investment in US Treasury debt and in physical assets (mostly commercial property and manufacturing plants). We entered the 1980s with attractive, double-digit US Treasury interest yields, created by the Fed in order to tame then-rampant consumer price inflation and also to pound the "gold-bugs" into submission. In stark contrast, we now have zero-percent short term US Treasury rates.....a Fed-created investing arena which is now so unattractive that money market fund managers may call it quits soon.

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, beginning March 9, 2009, had lost almost 20% by year end. On the other hand, The Peoples Bank of China has no such loss on its hundreds of billions of

UST-bills, because the Bank has "pegged" its currency at 6.83 yuan to the dollar*. Can this continue for very long? Not if you believe that the world's free markets are the Ultimate Adjustment Tool for all economic imbalances.

Jobs, Jobs

For some reason, perhaps drawn from roots in the government-heavy era of Franklin Roosevelt, the American public persists in a belief that its presidents "manage" the US economy. Good economic times are believed to reflect good presidential management and, conversely, any plain-vanilla business recession is laid, like dead meat, at the feet of the President (though this one blames his predecessor). Woe unto a president, if he must stand for re-election amid a recession. This time is no different. During President Obama's one year in office, the official unemployment rate has soared and he is deemed responsible for not creating jobs... or perhaps for not preventing job losses... it's actually a mystery as to what people expected would be done. Anyway, the President has got the message and so has the Congress; they all have resolved to make jobs their number one priority in 2010. We haven't a clue or a supposition about how that promise will translate into action.

The Urge to Regulate

It has become apparent that a broad swath of American voters is restless and unimpressed with the state of federal governance of the financial system. The Great 2008/09 Recession, having been squarely attributed to boundless risk-taking by financial organizations, has predictably sired a clamor for added regulation of them. Banks that already bounced back to profitability have also returned to their 2007-level (i.e., big) year-end bonuses, despite the predictable reaction of the American public (including those who aren't actually tax-payers).

*Unlike other major currencies, the dollar value of the yuan is essentially fixed by the Peoples Bank of China; the exchange rate has not changed for about 5 years. So, as the dollar declines against the Euro, the Yen and others, the yuan declines also, even though the Chinese economy is growing faster than almost any other on the planet. The result is no accident: China is an export-dependent economy with a cheapening yuan. Translation: foreigners (other than US) have been buying Chinese goods at attractive, declining