How Tinkering with Inflation Measurements May Have Led to the Current Financial Crisis

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Global Research, March 05, 2009
5 March 2009

Region: USA
Theme: Global Economy

> "There are three kinds of lies: lies, damned lies, and statistics." Mark Twain, (1835 – 1910)
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> "The Cost of Living [has been] replaced by the Cost of Survival. The old system told you how much you had to increase your income in order to keep buying steak. The new system promised you hamburger, and then dog food, perhaps, after that." John Williams, private economist
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> "The consumer price index is being understated by at least 1 percent per year." Bill Gross, professional investor
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> "… The development of credit derivatives has contributed to the stability of the banking system by allowing banks, especially the largest, systemically important banks, to measure and manage their credit risks more effectively. In particular, the largest banks have found single-name credit default swaps a highly attractive mechanism for reducing exposure concentrations in their loan books…." Alan Greenspan, Fed Chairman, May 5, 2005

Last February 20th, the U.S. Department Of Labor Bureau of Labor Statistics announced that, on a seasonally adjusted basis, the U. S. Consumer Price Index (CPI) increased by 0.3 percent during the month of January. Some independent economists, however, think that the real inflation rate is much higher, possibly as high as 7.52 percent. Why is that so?

The CPI is a measure of how much the price level of a basket of representative consumer goods and services, adjusted for predictable seasonal shifts, is supposed to have varied during a month or a year. Such a measure has been provided by the Bureau of Labor Statistics since 1919, covering the period between 1913 and today.

For many people, the CPI is less a measure of inflation than an imperfect measure for adjusting cost of living allowances. It is a technique that plays a central role in computing increases in the Cost Of Living Allowances (COLAs) of various money disbursements, incomes and wages. Some incomes, for example, such as Social Security payments and other entitlements, are statutarily adjusted upwards when the CPI goes up, and such adjustments have a direct influence on one's standard of living.

Economists have long debated the best methods of measuring inflation, especially as it affects the cost of living of various categories of consumers. This is a complex issue that involves statistical methods in calculating price indices, economic principles and notions of social justice. Moreover, not everyone is impacted equally by a rise in the overall level of consumer prices, depending on one's economic and financial situation. For example, for people living in a city and who are renters, a rise in the price of cars or of houses would not have the same predictable effect on them as it would on folks living in a rural area and who own their own homes. And it is not everyone who can deflect the negative impact of a rise in the price of consumer goods on their standard of living by substituting less costly items.

For the period between 1913 and 1982, the formula for measuring consumer inflation in the U. S. was pretty much straightforward. Government statisticians would periodically collect prices in certain identified areas with which the Bureau of Labor Statistics would then construct price indexes. Over time, surveys of consumer expenditures were conducted and the weight of different goods in the index would be adjusted accordingly to reflect people's new buying habits.

In the early 1980s, the Reagan administration feared that the standard CPI index overstated the impact of overall inflation on the cost of living of many recipients of government payments, the most important ones being Social Security outlays. The decision was then made to move away from the objective of having a general consumer price index measuring overall consumer inflation and adopt instead the policy of constructing a cost-of-living index that more closely reflected the true impact of inflation on different categories of consumers. That is why, since 1982, the CPI measurements that the Bureau of Labor Statistics publishes relates more to the cost of living, as defined and periodically revised, than to providing accurate information about the level of general inflation. [As a matter of fact, another government agency, the Bureau of Economic Analysis (BEA), has the responsibility to calculate a price deflator for consumption expenditures and other expenditures as part of the National Income and Product Accounts (NIPA).]

Indeed, in the mid-1990s, substantial changes were made to the CPI index which had the net result of lowering the official measure of consumer inflation. First, increases in asset prices, such as in housing, were only indirectly taken into account. For example, the 2002-2006 real estate bubble hardly registered at all in the CPI because only 'imputed' home rents for home owners were used in the index. At that time, rents were virtually stagnant in many cities due to overbuilding. Secondly, arbitrary downward adjustments were made in the prices of certain goods to reflect their enhanced quality. It is true that cars, TV sets or cellular phones are more performing today than their alternatives in the past, and this raises people's standard of living. However, such goods cost more, and the higher prices are not fully recorded in the CPI. Thirdly, and maybe more debatably, in order to concentrate on the impact of price increases on the true cost of living, it was assumed that consumers adjust to higher prices of certain items by substituting relatively less costly goods when relative prices change. For instance, buyers would be assumed to switch from steaks to hamburgers or from beef to chicken when the price of steaks or beef increases. Similarly, people would tend to switch from high-priced stores to discount stores when their incomes do not follow inflation. It can also be assumed that such forced substitutions are not without inconveniences or hardships for the consumers, and thus could indicate a lowering in their standard of living. Nevertheless, these modifications that lowered the official measure of the CPI were incorporated into new statistics from 1982 on.

Consequently, it has become somewhat risky to rely on official CPI figures to obtain a true assessment of inflation. Because of all the changes made in the CPI index since 1982, the CPI has become less and less a true measure of consumer inflation, even though it may or may not more closely reflect the true impact of inflation on people's cost of living. For the overall economy, it is fair to assume that the true inflation rate is substantially higher than what is reflected in official CPI announcements, and this has a compounding effect overtime.

For its part, since February 17, 2000, the Fed uses a “core” chain-type price index for personal consumption expenditures (CTPIPCE), i.e. a price measure for all items less price increases in food and energy. What is at stake here is the danger that government officials may begin to believe their own official inflation figures which are understated, maybe for good reasons as far as cost of living issues are concerned, but nevertheless severely understated as far as the true inflation rate is concerned. This has the potential for disastrous consequences, not only for the public in correctly judging inflation pressures for investment purposes, but also for public officials in framing policy, especially monetary policy.

The most recent example is provided by the pronouncements that Fed officials made during the crucial 2003-2005 period, when a dangerous housing bubble was building up speed and when financial firms were embarking upon riskier and riskier financial schemes. To a man, Fed officials denied there was any risk of inflation and, contrary to what everybody could see, declared that there was no housing bubble going on.

For instance, on March 1, 2003, the No. 2 man at the Federal Reserve, Fed Gov. Donald Kohn insisted that the extremely low short-term interest rates that the Fed was keeping down had not created a speculative bubble in real estate.

In 2004 and in 2005, Fed Chairman Alan Greenspan himself echoed Mr. Kohn and repeated many times that there was no inflation and that he was in no hurry to raise short-term interest rates from their 46-year low level of 1 percent. In April 2004, for example, in remarks on the economic outlook to the Joint Economic Committee, Greenspan remained unconcerned about inflation, declaring that “as yet, the protracted period of monetary accommodation has not fostered an environment in which broad-based inflation pressures appear to be building”, just at a time when the housing bubble was but one year from its final top.

At that time, the old pre-1982 CPI formula, as calculated by private economists, indicated that U.S. consumer inflation was above 8 percent and that a housing bubble and a concomitant stock market bubble were in full swing. Future Fed Chairman Ben Bernanke, then a Fed Board member, echoed his mentor in late 2005 by saying that there was no housing bubble to go bust and that the fact that U.S. house prices were rising four times faster than the economy was “largely [a reflection of] strong economic fundamentals.”

But, it is now generally agreed that from 2002 to 2004, the American central bank pursued a monetary policy that was too expansionary and that—plus the lack of government regulation of the derivative market—contributed greatly to create the conditions for a major financial crisis. Let us keep in mind that in 2004, the Fed Chairman was publicly recommending that people buy adjustable rate mortgages (ARMs), especially interest-only adjustable-rate mortgages, and other subprime loans instead of safer fixed rate loans.

As a matter of fact, most economists agree that interest rates should have been raised as early as 2002. But Mr. Greenspan implied later that he was forced to play politics with his monetary policy, when he declared on September 17, 2007, in an interview with the Financial Times, that “raising interest rates sooner and faster would not have been acceptable to the political establishment given the very low [official] rate of inflation”.

There you have it. What is suggested here is that the push to reelect President George W. Bush, in the fall of 2004, may have played an important role in letting the housing bubble become bigger, thus paving the way for a housing bubble burst in 2005-2006. This is, by the way, on top of the confession that Mr. Greenspan made in his Memoirs (The Age of Turbulence) that he had personally lobbied the Bush-Cheney administration in favor of the unprovoked 2003 U.S. war against Iraq, and that consequently, he was personally tied to the overall political agenda of the Bush-Cheney administration.

When the history of this financial and economic crisis is written, it shall be recorded that the Fed and other government agencies, such as the Securities and Exchange Commission (SEC), did little or nothing to prevent the debt pyramid from reaching the dangerous levels it attained and which is now crashing down, dragging down with it the entire U.S economy and most of the world economies.

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