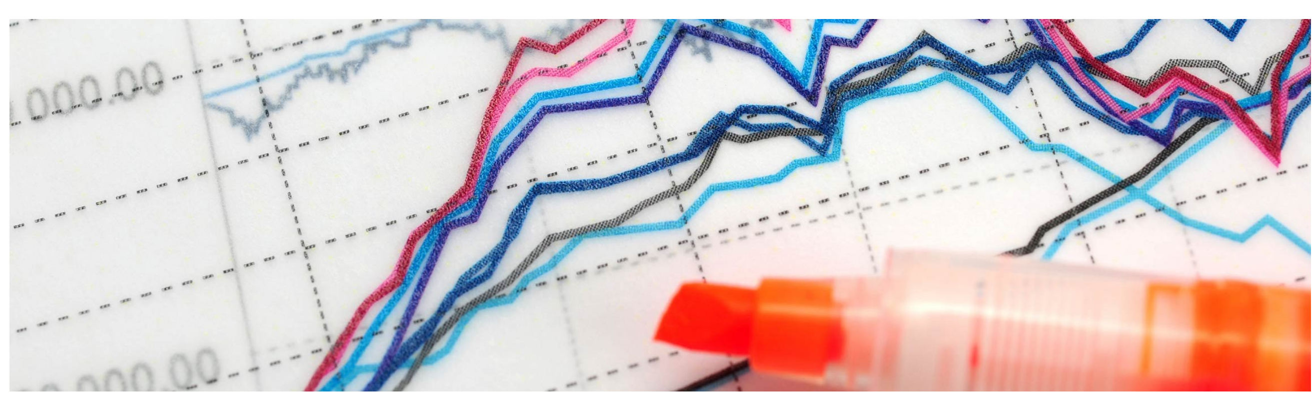
The Risks of Relying on an Inaccurate Inflation Measure

by Martin Hochstein | 08/01/2018



Summary

The jury is still out on whether official CPI indices over- or underestimate inflation, but the latter would have consequences that reach far beyond consumers. Key macroeconomic data might be inaccurate, public spending could be too low and investors could suffer from the "stealth devaluation" of important assets.

Key takeaways

- For years, consumer-price inflation has been puzzlingly low; official figures may be flawed and not reflective of actual experienced inflation
- CPI's key shortcomings: it isn't a true fixed "basket", it suffers from contentious quality adjustments and it's biased towards higher-income households
- If inflation is being underestimated, social security and income inequality could suffer, and risks to financial stability may increase
- Central banks should pay more attention to asset-price inflation, and investors should consider real assets as an inflation hedge and diversifier

Despite the expansionary monetary-policy measures enacted by central banks in the aftermath of the global financial crisis, consumer-price inflation has remained puzzlingly low in most parts of the world. This raises concerns about whether inflation is being measured accurately. Do official figures reflect actual experienced inflation – and if not, what are the implications for central banks and investors?

What's wrong with CPI?

One of the most widely used measures of consumer-price inflation in the United States is the Consumer Price Index (CPI), which strives to assess the average change in the prices consumers pay over time for a "basket" of goods and services.

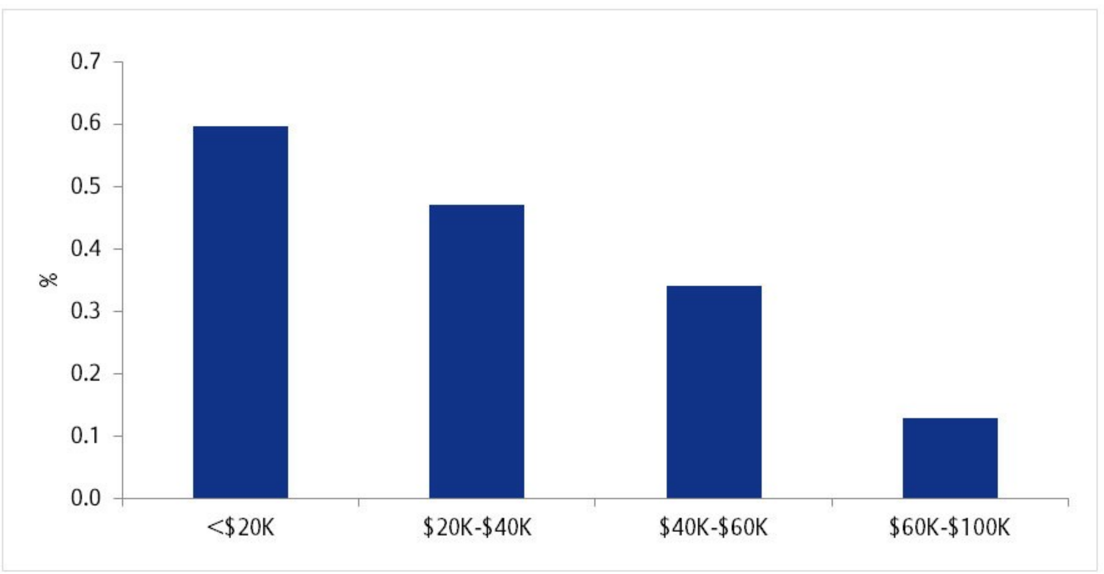
Yet although CPI has a relatively simple definition, the devil is in the details. Its calculation depends on a range of often contentious methodological assumptions and quality adjustments, making it an imperfect measurement of "true" inflation. It is also worth noting that while we are using CPI in the US as an example, similar official measures exist in other economies, and many have related flaws.

Here is a summary of several ways in which CPI falls short:

- *CPI is an incomplete cost-of-living measure – not a true fixed basket.* CPI aims to capture the market-based cost of certain goods and services needed to maintain a constant standard of living. However, this basket and its weightings are not fixed; instead, they change with underlying shifts in consumer preferences. While this adjustment is made to reflect changing consumer situations, it results in inconsistency in the index over time.

- *CPI covers goods and services, but excludes asset prices.* With a focus on consumers' day-to-day living expenses, CPI excludes intermediate goods and asset prices. Theoretically, excluding asset prices seems justified, but it creates at least two major problems. First, some assets like owner-occupied housing represent a grey zone, since they are very long-lived assets but also provide immediate shelter service – the costs of which are not readily observable. Second, central-bank mandates are too narrowly focused when goods and service prices diverge widely from asset prices. This is the case today: since the global financial crisis, asset prices have experienced an inordinate amount of inflation.
- *CPI isn't representative of median- or lower-income households.* The relative weights of CPI basket items are based on a survey of aggregated consumer expenditures, which makes CPI more representative of the upper third of the income spectrum. Median and lower-income households tend to have different consumption patterns, as do older people, so these groups often suffer from higher inflation than the level indicated by official CPI data.

Median- and Lower-Income Households Face Higher Inflation Rates
Consumer inflation differential vs. household income greater than USD 100K (average per year, 2004-2013)



Source: Kaplan/Schulhofer-Wohl (2016) "Inflation at the Household Level". Data as at 2013. Chart is in USD, based on median household-level prices in the United States.

What happens if CPI is inaccurate?

While the battle in academia over the question whether inflation is overestimated or underestimated by official CPI indices rages on, an understatement would have far-reaching consequences beyond what is experienced by consumers:

- *Real GDP and productivity growth figures could be too high.* Important macroeconomic data points that factor in the rate of inflation could be inaccurate if inflation itself is being underestimated.
- *Public spending could be suppressed.* Social security and other spending measures indexed to inflation would be too low if "true" inflation were higher than what the official numbers reported.
- *Inequality could rise.* Income inequality is already pronounced, and it could get worse if lower-income households continue paying real-world costs that are not reflected in the official data, and if social security and other spending measures stay linked to faulty inflation rates.
- *Businesses could be watching bad signals.* Corporate decision-makers depend on accurate inflation numbers to formulate valid long-term business plans and take appropriate shorter-term business decisions.
- *Risks to financial stability could rise.* A too-narrow inflation objective has prompted central banks to implement what we believe are overly accommodative policy measures. This, in turn, has pushed up asset valuations in ways that are not fully backed by fundamentals.

How should policy makers and investors respond?

We believe that central banks can no longer afford to have an attitude of "benign neglect" towards the potential creation of asset bubbles. Their official target functions should be changed so they pay more attention to asset-price inflation in addition to continuing their focus on employment and goods- and services-based inflation. Aligning monetary policy with the financial cycle rather than predominantly with the business and inflation cycle may help prevent a build-up towards a financial crisis – or at least mitigate its negative consequences if another one were to erupt.

If official price data is indeed understating the loss of purchasing power, investors should prepare for a "stealth devaluation" of nominal (or intangible) assets such as bonds or money market instruments. Accordingly, investors should consider making an appropriate strategic allocation to real assets such as equities, real estate and commodities, which may be able to provide a proper inflation hedge and a means of diversification.

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He previously worked at Cominvest and Deka as a global fixed income portfolio manager and was Head of Fixed Income and Money Markets at SEB Invest Germany. He graduated with a master's degree in business administration from the University of Siegen and is a CFA charterholder since 2003.

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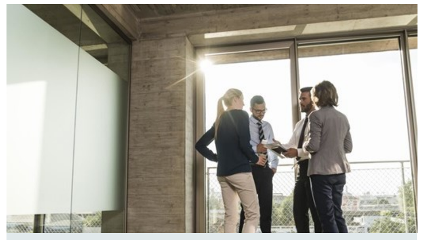

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Summary

Our strategists, economists and portfolio managers recently convened in Hong Kong to reflect on the state of the global economy today – and its direction over the next 3-5 years. The gradual tightening of monetary policy could bring a return of volatility, especially in developed markets, but Asia in general and China in particular are bright spots.

Key takeaways

- The competing factors of geopolitical turmoil, demographic change and technological advancement will make for an interesting if uncertain investment climate in 2018
- The scale of central bank support is diminishing globally, but we expect the overall shift to be slow; income opportunities abound for investors willing to look beyond benchmark bonds
- The outlook for China and Asian markets overall remains favourable – so much so that one of the biggest risks to investors' portfolios may be an "unconscious" underweight to China
- Disruptive business models are reshaping investment opportunities across the globe; the US and Europe will need to respond to high-tech competition from China

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