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CPI Plays Shell Game with Costs



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Andre Ratkai is a chartered financial analyst, a professor at the University of Denver and president of a private investment firm called the Praxis Advisory Group.

With the aid of student researcher Gregory Throckmorton, he's come to a conclusion about government inflation reports that you may have already reached after balancing your checkbook.

"The cost of living is going up a lot more than officially reported," he said. "And the evidence is that people are having to take money out of their house to pay for things."

Income growth has been stagnant since 2001. But the consumer has kept the economy going with home- equity loans.

And all this time, the constant refrain we've heard from government economists and the Federal Reserve is that inflation is in check. But since the 1990s, they've been tweaking the way they report the Consumer Price Index. And these tweaks, says Ratkai, ensure that inflation is grossly underreported.

The introduction of "core CPI" was one such adjustment, Ratkai writes in his December newsletter. Core CPI excludes two of the most essential things human beings do: eat and consume energy.

When gasoline prices skyrocket — inevitably pushing up food-production and -distribution costs — economists still assure us that core inflation is benign.

When core inflation was introduced in the 1990s, the price of oil wasn't skyrocketing as it is today. It was merely fluctuating from month to month, and government economists reasoned that these fluctuations were meaningless. With \$3 gasoline, they don't seem meaningless today.

Another debated change to CPI is the "hedonic adjustment," which was first adopted for computers in 1998 and then expanded to everything from televisions and cars to even college textbooks — which, by the way, are still boring.

The hedonic adjustment tries to take into consideration improvements in quality, often because of better technology. For instance, today's automobiles have more computer-assisted devices than they had 10 years ago, and their higher price reflects that technology. The problem is that consumers still have to buy a car, whether they want this technology or not, and they don't find it as inexpensive as economists suggest.

In an era of rapid technological change, government economists have to find some way

to measure quality improvements. There is no perfect way to do this.

No one, however, has suggested that in calculating inflation we measure decreases in quality — such as the service one gets from their airline, health-care provider or cellphone company. Next time you meet a government economist, ask this: Are lead-painted toys from China really holding down inflation?

The CPI is also calculated using a concept called substitution. The theory goes that if, say, aluminum studs become cheaper than wood studs, builders will switch to aluminum and the price of wood is rendered irrelevant.

The problem is the assumption that everyone will make this substitution.

The government has a vested interest in keeping inflation in check. Social Security benefits are indexed to inflation. So are various government contracts and issues of government debt. Corporations with inflation-indexed contracts benefit as well.

"Billions of dollars in transactions hinge on tenths of a percentage point change in this key economic indicator," Ratkai wrote. Ultimately, though, if inflation is higher than actually reported, growth in our nation's gross domestic product is lower than reported. So we're not humming along as well as our leaders would have us believe.

"I'm really troubled by Wall Street's sheeplike acceptance of the reported CPI," said Ratkai. "It's created unreal expectations for stock valuations."

How else can they sell us stocks?

"If we are to avoid distorting our economic progress and prevent deluding ourselves into becoming a second-rate economy," Ratkai said, "Democratic and Republican policymakers alike should seek a more realistic measure of price inflation."

I particularly like an index offered annually since 1984 by a Pittsburgh-based firm, PNC Wealth Management. PNC measures the cost of items mentioned in "The Twelve Days of Christmas."

This year, it's up 4 percent to \$78,100.

A recent hike in the minimum wage, for instance, pushed the cost of eight maids a-milking from \$41 to nearly \$47.

Rising gold prices pushed the cost of the five golden rings to \$395 from \$325 last year. And 10 lords a-leaping? They'll cost \$4,285, up from last year's \$4,160.

Even our government economists should have seen this coming, though.

If there's one thing we know about lords, they always want more.

Al Lewis' column appears Sundays, Tuesdays and Fridays. Respond to him at denverpostbloghouse.com/lewis, 303-954-1967 or alewis@denverpost.com.