The CPI Measures Inflation and Other Widely Believed Economic Nonsense

The Fed, mainstream media, and others have a spotlight on the CPI and that's the wrong spotlight.

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Chart Discussion

In the chart above I plot the Case-Shiller national home price index, the Case-Shiller 10-city index, the CPI, Owners' Equivalent Rent (OER), and the BLS Rent Index.

I have produced this chart previously, but this month I added the BLS Rent Index.

OER is the mythical price one would pay if one rented their own house from themselves, unfurnished and without utilities.

Prior to the year 2000, housing, rent, OER, and the CPI all moved in sync. In 2000, home prices disconnected from the CPI, OER, and rent.

In 2012 another disconnect developed in which both rent and OER also disconnected from the CPI.

If we plotted actual medical prices (not the BLS measures of them), we would see that the cost of healthcare disconnected from the CPI as well. That happened because the CPI does not include prices paid on behalf of consumers (i.e. Medicaid, Medicare, or your group plan where you work).

The two enormous bubbles (you do see them don't you?) are the direct result of the Fed sponsoring bubbles.

Debate Over the CPI

Debate Over the CPI Image not found or type unknown

CPI Is Understated

I made the statement that the real CPI is understated. Actually, that's not phrasing things properly.

More accurately, the CPI is a piss poor measure of inflation. Which led to the comment "Housing prices lead rent, no?"

> https://twitter.com/MishGEA/status/1415092036143697921?s=20

Slaves to the CPI

The Fed and economists in general are slaves to CPI despite the facts

- The CPI does not measure inflation
- Consumer prices do not properly measure price inflation
- The entire notion we need 2% inflation while ignoring asset bubbles that allegedly do not represent inflation is downright idiotic.

Measured Price Inflation MPI

A better measure of inflation can be calculated by substituting actual home prices for OER in the CPI.

To satisfy the purists who say that home prices are a capital expense, let's not call the result "consumer" inflation but rather MPI measured Price Inflation.

I called it Case-Shiller CPI but will change the name next month to better reflect what it really is and to stop futile discussion of the word "consumer".

Those who want the CPI can have it. As an inflation measure, especially as used by the Fed, it's proven useless anyway.

The nice thing about Case Shiller is the index measure actual resales of the same house over time. We can debate the weights but OER is at least a reasonable place to start.

Weights in the CPI

> CPI percentage weights 2020

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Home Owners Equivalent Rent

Notice that OER is the largest component at 24.6% of the CPI and rent of primary residence is another 7.86%.

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In the last year, home prices are up 14.59%, the CPI is up 5.39%, but OER only 2.34% and Rent only 1.92%.

OER and rent have held down the CPI considerably.

These inflation stats are understated because the latest CPI data is from June but the latest housing data is from April.

I created the above charts using an assumption that home prices were flat in May and again in June although we know prices went up.

CPI, CS-CPI Percent Change

> CPI, CS-CPI Percent Change 2021-06
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The above chart shows the impact of substituting home prices for OER in the CPI.

Real Interest Rates

> Real Interest Rates CPI as of 2021-06
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Real rates are formed by subtracting various interest rates from the Fed Funds Rate, a minuscule 0.08%.

As such, real interest rates, factor in housing, and are about -7.5%. But that does not include home price increases in May or June.

Real interest rates are more deeply negative than right before the housing crash.

The Fed is purposely allowing inflation to run hot, and that does not count home prices at all, just rent.

Monetary Inflation vs Price Inflation

Some say that the increase in money supply is inflation and prices follow. But money measures themselves are very distorted and people bicker over how to measure them too.

I will discuss monetary inflation next week, so stay tuned.

Historical Perspective On CPI Deflations

In its March report, the BIS took a look at the **Costs of Deflations: A Historical Perspective**. Here are the key findings.

> Concerns about deflation ? falling prices of goods and services ? are rooted in the view that it is very costly. **We test the historical link between output growth and deflation**

> **in a sample covering 140 years for up to 38 economies. The evidence suggests that this link is weak and derives largely from the Great Depression**. But we find a stronger link between output growth and asset price deflations, particularly during postwar property price deflations. We fail to uncover evidence that high debt has so far raised the cost of goods and services price deflations, in so-called debt deflations. *The most damaging interaction appears to be between property price deflations and private debt*.
>
> ***Deflation may actually boost output. Lower prices increase real incomes and wealth. And they may also make export goods more competitive.***
>
> *Once we control for persistent asset price deflations and country-specific average changes in growth rates over the sample periods, persistent goods and services (CPI) deflations do not appear to be linked in a statistically significant way with slower growth even in the interwar period*. They are uniformly statistically insignificant except for the first post-peak year during the postwar era ? where, however, deflation appears to usher in stronger output growth. ***By contrast, the link of both property and equity price deflations with output growth is always the expected one, and is consistently statistically significant***.

CPI Spotlight Is Wrong!

The BIS clearly draws the line on asset bubbles and property bubbles and so do I.

The data shows the Fed has made the same mistake again, insisting on 2% CPI inflation while ignoring asset bubbles on grounds they are not inflation.

The Fed has a spotlight on the ant, missing the elephant in the room that it created.

I will update the charts again when the next Case-Shiller reports come out.