Revisiting the Measures of Inflation

September 13, 2021

Tomorrow we will get an update on the latest measure of inflation, the consumer price index, for the month of August. We anticipate the number to be higher than expected as the overall economy continues to expand as the consequences of the Covid virus continue to wane. Even though there is general acceptance that inflation is a threat to the economy via a tighter Fed policy, other measures of inflation are not signaling that threat. Here are a few of our favorite examples:

The stock market is hitting new highs even though the months of August and September are not favorable for stocks. Similar results are occurring in world stock markets. If inflation were imminent, investors would be bracing themselves for tougher times in the markets.

Interest rates remain near record lows. Even though the Federal Reserve continues to buy bonds, the private sector is also buying bonds despite paltry returns. A surging global investment pool is providing continuing demand for fixed income securities.

The price of gold, a historical indicator of increasing inflation, has been stable. As of last Friday, the price was $1,790 per ounce, down more than 5% year to date.

The U.S. dollar is up 3% year to date. If inflation was a threat, then we would expect to see weakness, not strength, in the dollar.

Lastly, what about all these news reports about the costs of goods and services rising rapidly? The problem with translating these “cost” increases into some measure of inflation ignores the fact that one person’s cost is another person’s income. These so-called expenses are essentially a wealth transfer from the buyer to the seller. The real measure of inflation is not tracking changes in transaction prices but measuring whether overall economic activity is expanding, not contracting. What usually happens when there is a rise in prices due to a surge in demand is that the private sector is quick to respond by increasing capacity that raises the volume of goods and services and allows prices to return to a reasonable level. One only has to look at the rise and fall in the price of lumber this year as the industry worked to increase capacity. Another example is the recent shortage in computer chips and the announcement by Intel that it is planning to spend over $90 billion dollars to build two chip plants in Europe.

Consumers can react quickly to most price increases by substituting other products or services. This option was not available in the inflation of the 1970s because the leading cause of inflation then was an OPEC-induced shortage of oil and a quadrupling of oil prices. Oil and its derivatives are such an important component of our economy that the oil embargo and price increase contributed to the bear market of 1974-75. The falling reliance on oil imports and the U.S. surge as a global producer of oil on the back of fracking technology minimizes the chances that there would be a man-made shortage of a good or service that would bring about a repeat of such an experience. If the economy continues to grow, we do not foresee inflation being a serious problem.