Inflation and its "Secret" Ingredients

May 30, 2023

A couple of weeks ago, the monthly consumer price index (CPI) data was released and showed a rise of 0.4% for April and a corresponding annual rate of 4.9%, both higher than the March print. These statistics troubled analysts and economists and made the majority believe that the Federal Reserve will continue to tighten by raising interest rates to stem further increases in inflation. In addition to the monthly CPI, there is the monthly Core-CPI which consists of fewer ingredients than its more comprehensive measurement. The latter is meant to allow for a less volatile gauge as both energy and food prices tend to be more volatile. The other components of the CPI include housing, owners' equivalent rent, new vehicles, used vehicles, medical care, and services ex-energy. Shelter was once again the main ingredient in the CPI number last month and is up 6% for the past twelve months due to rising housing costs during COVID in 2020-2021. Imputed rent has also been running high.

Now that we know what ingredients go into producing the CPI and CPI ex-food and energy, let's drill down to identify any "secret" ingredients that might be overlooked. Traditionally, economists like to "blame" inflation on corporations that are raising prices—known as demand-pull inflation—or on rising wages (often due to union demands) which is called cost-push inflation. On any given day you can hear politicians complaining about rising prices and attribute that increase to "greedy" corporations or "greedy" unions. Last year the run-up in the price of oil gave politicians plenty of ammunition to attack the oil companies for windfall profits. Of course, the subsequent fall in oil prices did not bring forth a mea culpa.

One "secret" ingredient is the role that the government plays in how prices are set. Various government actions can force corporations to raise prices just to stay in business, i.e., increasing regulations. Complying with new and existing government regulations is costly. Congress puts out thousands of pages of regulations each year and individual agencies compound the problem by adding their interpretation to these regulations. State regulatory bodies play a similar role here too. According to Wikipedia, Congress has enacted approximately 200–600 statutes during each of its 115 biennial terms. There are now more than 200,000 rules in the Federal Code of Regulations!! These regulations or "secret" ingredients have never been considered in measuring inflation yet have been contributors since 1921 when the indicator and the time series back to 1913 were established.

The government's role in contributing to inflation does not stop with regulations. The government's decision to increase spending and increase tax rates (or introduce new taxes) has an impact on prices and thus contributes to the measures of inflation. Additionally, excess government spending that creates a demand for goods and services drives prices up while periodic tax increases not only add to corporate costs but to consumer behavior.

Monetary policy is also a "secret" ingredient to the broad CPI inflation measure. Stay Tuned!

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