

The AIER Cost-of-Living Guide

Price inflation accelerated in 2004. The Consumer Price Index (CPI) increased by 3.4 percent in the first 11 months of the year, almost double the increase in 2003. Energy prices led the way, but price inflation accelerated significantly even after excluding energy prices.

The CPI has now increased every year since 1955. Looking further back, the purchasing power of the dollar has fallen by over 90 percent since 1913. That's the same year that Congress created the Federal Reserve System, which, as the Nation's central bank, is now supposed to "fight" price inflation.

In our view, this long-term erosion in purchasing power is likely to continue as long as the United States retains a fiat currency. All the currencies of the world today are fiat currencies – that is, currencies that promise to pay nothing except more of the same currency and that are legal tender (usable to extinguish debts and obligations) because their issuing governments say so. This system stands in sharp contrast to a gold standard, in which currencies are defined as or redeemable in specific weights of gold.

The problem with fiat currency systems is that they lack the self-correcting mechanisms of a gold standard; if prices

increase too much, there is no built-in mechanism to bring them back down. The historical evidence over many centuries and governments suggests that governments tend to follow fiscal and monetary policies that foster higher prices. In the absence of a gold standard, there is little to restrain them from printing fiat money to excess. *All* the fiat currencies of the world have lost value over the years, and none is immune from the rot of officially-sponsored inflating.

Taking a Long View

A review of the historical record provides a stark reminder of how ineffective the U.S. government has been at preserving the purchasing power of the dollar. As shown in Chart 1, for more than a century the general price level in the United States fluctuated periodically in response to a series of wars and panics. From the Revolutionary War through World War I, wartime monetary excesses were followed by postwar decreases in prices. The sharp upturns in prices preceding the three peaks shown in the chart coincide with the War of 1812, the Civil War, and World War I.

During each of those episodes when the dollar's purchasing power plunged, the currency's redeemability into monetary

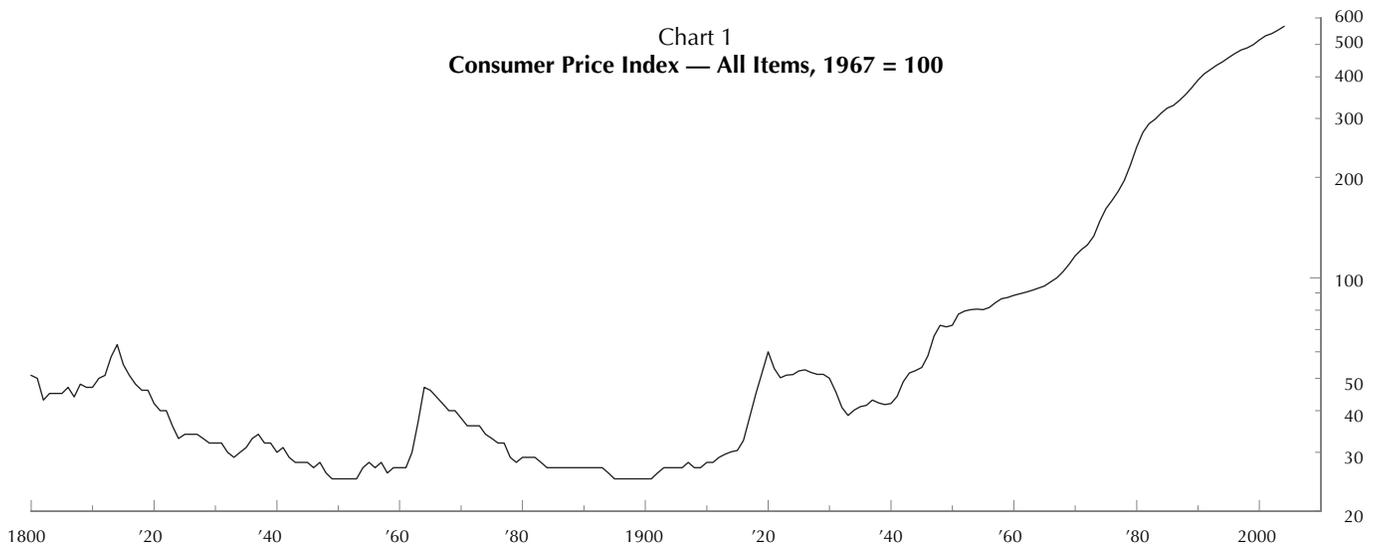
commodities (gold or silver) at fixed rates was impaired. After convertibility was restored, prices began to return to their prior levels. From the perspective of modern experience, it may seem astonishing that *the price index in 1930 was exactly the same as it had been in 1801, 130 years earlier.*

A sea change in the movement of the general price level followed the abandonment of the domestic gold standard in 1933 and the subsequent suspension of gold redeemability in 1971. As Chart 1 shows, the purchasing power of the dollar has eroded almost continuously since the early 1930s. There has been no reversal of the price trend such as occurred previously when the dollar returned to convertibility.

Measuring Price Changes

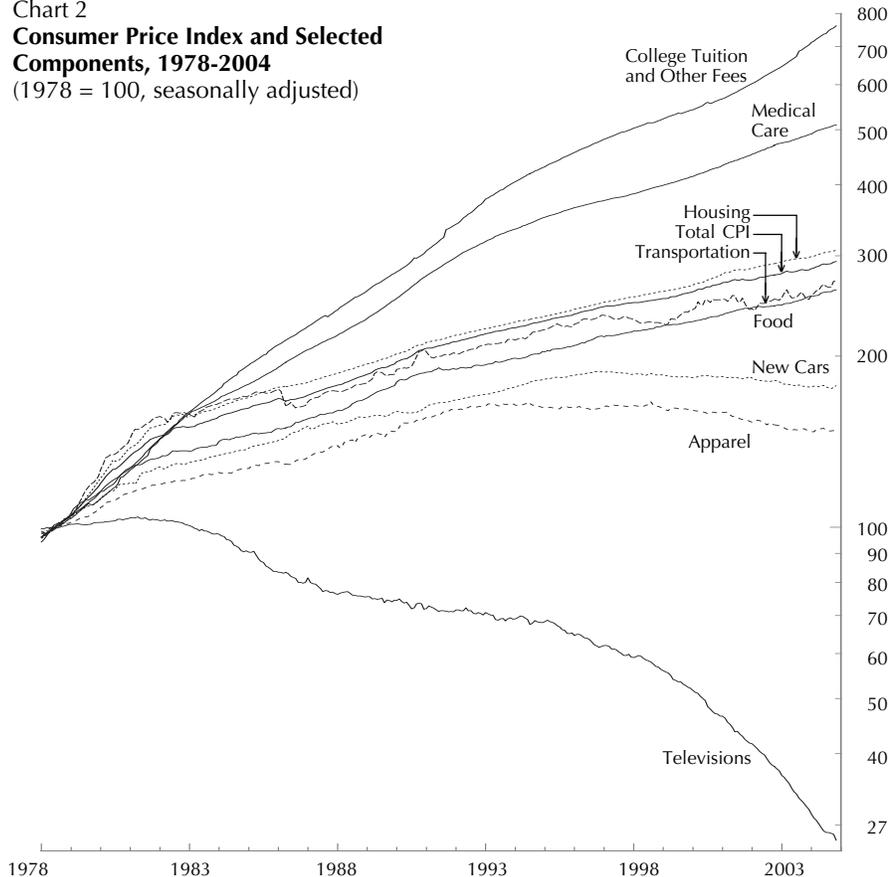
There is, of course, no such thing as a "general price level." Price indexes attempt to summarize the prices paid by millions of different individuals for the myriad goods and services produced in the overall economy. The CPI, the most widely used barometer of overall price inflation, was developed during World War I, when the unprecedented economic mobilization that was undertaken to meet the urgent demand for arms, munitions, and equipment led to rapid increases in prices, particularly in shipbuilding cities. This created the need for a cost-of-living

Chart 1
Consumer Price Index — All Items, 1967 = 100



Note: Prior to 1913 index largely is based on prices for goods rather than goods and services, and on wholesale rather than retail prices.

Chart 2
Consumer Price Index and Selected Components, 1978-2004
 (1978 = 100, seasonally adjusted)



index to use in wage negotiations. In later decades, as price inflation became chronic, the CPI was increasingly used to make cost-of-living adjustments to a wide range of contracts and payments, including wages, Social Security benefits, other government programs, and the tax code.

Although the CPI is one of the most widely-reported economic statistics, few people understand how it is calculated. It measures the change in the price of a “basket” of goods and services. The first step is to find out what people buy, and the Bureau of Labor Statistics (BLS) does this by surveying consumers. The survey currently used is believed to represent the spending habits of about 80 percent of the population. The price inflation experienced by the other 20 percent—mainly persons living in rural areas—may not be accurately measured by the CPI.

Currently over 400 items are included in the CPI, covering spending on food, transportation, household operation, education, recreation, etc. When the prices of all these items are combined to construct a “general price level,” the price of each item is weighted according to the proportion of income that consumers spend on it. For example, people spend more on housing than they do on fruit, thus housing costs are given more weight than the price of fruit in the CPI.

In actual experience, of course, people

do not spend the same proportion of income on the same items every year. Tastes change. Moreover, in a dynamic economy such as that of the United States, new or improved products continually become available, while others become obsolete. To account for this, the CPI basket of goods and services is changed every few years to reflect new information on what people are buying. Even so, the index can have difficulty keeping up with innovations and changing tastes. Furthermore, the prices of new items often drop sharply after they are introduced (e.g., DVDs) but, because new items are not added to the CPI for some time, the index misses these decreases, a factor that works to make the CPI overstate price inflation.

In addition, shoppers often juggle their purchases to take full advantage of “good buys,” and thus are able to reduce their total expenditure. The index does not always capture this so-called “substitution effect.” It probably also fails to fully account for special pricing practices, such as rebates, senior discounts, frequent-flier miles, cash-back plans, etc. Moreover, CPI price data are not collected on weekends or holidays, when stores have sales and

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many consumers shop. All these shortcomings tend to cause the CPI to overstate the impact of price increases on the cost of living.

Perhaps most important, however, the CPI may not be adequately adjusted for quality improvements. In theory, the index measures the prices of items whose quality remains constant over time. In other words, if a price increase for a good is accompanied by a comparable quality improvement, this increase should not affect the CPI. In practice, putting a price tag on quality changes can be tricky. If a new medication costs \$10 more but it causes fewer side effects, is the increase in the price attributable to this improvement? If so, the “constant quality” price has not increased. If airlines offer a greater choice of flights, or they eliminate meals and shrink their seat space, how should analysts account for this when measuring changes in the price of “constant quality” air travel?

The BLS, which computes the CPI, takes quality changes into account when pricing some items, such as cars and computers. But it ignores them for many other goods and services. Some economists believe that, on balance, the quality of goods and services has increased more over the years than indicated by these quality adjustments. To the extent this is so, the CPI overstates price inflation. However, the degree to which economists (or, perhaps more importantly, consumers) agree whether the CPI understates quality improvement is still an open question, and efforts to “improve” the index in recent years may be leading to a new source of downward bias.

It would be all but impossible to avoid completely these pitfalls in the computation of the CPI. Despite its shortcomings, it may be the best available measure of changes in the cost of living, if that is described as the dollar outlays required to reach a given level of consumer satisfaction.

A breakdown of the CPI into broad categories of goods and services, as shown Chart 2, reveals where price pressures were greatest for the past 25 years. Consumers who purchased relatively more of the items near the top of the chart suffered a larger increase in their cost of living than that implied by the increase in the aggregate CPI. Those who spent more on the items shown near the bottom experienced a relatively smaller increase.

Recent Price Changes

Chronic price inflation even at “moderate” rates leads to significant losses of buying power over time, a fact often obscured by media reports that focus on com-

paratively small monthly or annual price changes. For example, during the past decade, the rate of price inflation averaged 2.5 percent per year - but the dollar lost more than 20 percent of its purchasing power.

The accompanying table shows a detailed breakdown of consumer prices, revealing the cumulative price changes in goods and services from the beginning of 1990 through November 2004. An eclectic mix of services and commodities lead the list, including educational and medical care services as well as cigarettes, tomatoes, and oranges. At the other extreme, the prices of (constant quality) personal computers and other information-processing equipment have plummeted over 80 percent, with other electronic appliances showing significant long-run price declines as well.

Prices are influenced by countless forces of supply and demand including technology, demographics, changing tastes, product innovation, international competition, and even the weather (the Florida hurricanes appear to be the main factor behind the recent surge in tomato and citrus prices). However, government policies are another important source of price pressures, and it is notable that prices have increased the most for items that are heavily influenced by such policies: tobacco is heavily taxed, and the cost of education and health care continues to soar despite (or perhaps because of) efforts to make them more affordable. Oppositely, consumer prices for video and audio products, a lightly regulated industry, have sharply decreased.

The relationship between government policy and the costs of obtaining goods and services is, of course, not as simple as these examples might suggest. Myriad policies distort prices, and it is all but impossible to identify the relative impact of different, sometimes conflicting, policies.

In addition, government policies affect not only the prices of items but their availability. Policies that artificially limit price increases also tend to limit supply. When this happens, low prices do not necessarily reflect a lower cost of living, or a higher standard of living. Witness the long lines in the former Soviet Union for “cheap” goods, and the long waiting lists for medical services in countries with “low-cost” national health insurance.

In turn, rising prices do not always imply a corresponding increase in the cost of living. In this regard, the sharply higher prices that typically arise when countries abandon central planning can overstate the impact on their standard of living. The higher prices are offset, at least to some

PERCENT CHANGES IN SELECTED PRICE INDEXES

1990 — 2004

<i>Item</i>	<i>% Change</i>	<i>Item</i>	<i>% Change</i>
Tomatoes	201.3	Frozen vegetables	40.6
Cigarettes & other tobacco products	178.3	Eyeglasses & eye care	40.5
College tuition and fees	172.2	Telephone services, local charges	40.3
Elementary & high school tuition & fees ...	166.4	Snack foods	38.9
Hospital services, nursing homes, adult day care	152.4	Frankfurters	38.8
Oranges & tangerines	148.1	Wine at home	37.3
Cable television	122.3	Margarine	37.3
Household fuel oil	120.5	Rice, pasta, cornmeal	37.0
Educational books & supplies	116.9	Fish & seafood	36.6
Bank services, tax return preparation, other financial services	112.5	Sugar & sweets	35.2
Housing at school, excluding board	109.6	Breakfast cereal	35.0
Dental services	108.5	Pork chops	34.3
Bacon & related products	104.5	Nonprescription medical equipment & supplies	34.1
Legal services	101.7	Housekeeping supplies	28.1
Gasoline (all types)	98.5	Nonprescription (over-the-counter) drugs ..	27.6
Prescription drugs & medical supplies	97.7	Stationery supplies & gift wrap	27.0
Funeral expenses	95.9	Pets & pet products	25.5
Utility natural gas service	95.0	Coffee	25.1
Butter	91.2	Shampoo, cosmetics, perfume, & other personal care products	23.3
Motor vehicle insurance	91.1	Electricity	22.6
Garbage & trash collection	89.6	New trucks	21.6
Out of town lodging, incl. hotels & motels	89.5	Bananas	20.4
Admissions to movies, theater, sporting events, etc.	89.0	Frozen & freeze dried prepared foods	16.3
Water & sewerage maintenance	88.3	Used cars & trucks	14.7
Fees for lessons or instructions	87.4	Sports vehicles including bicycles	14.3
Lettuce	83.4	New cars	11.2
Physicians' services	82.3	Women's footwear	11.0
Apples	79.9	Furniture & bedding	11.0
Bread other than white	76.6	Carbonated drinks	10.3
Lamb & organ meats	71.3	Vehicle parts & equipment other than tires	8.2
Alcoholic beverages away from home	71.1	Boys' and girls' footwear	5.9
White bread	70.2	Eggs	5.8
Airline fare	69.9	Watches	4.9
Public transportation within city	68.2	Tires	4.1
Crackers, bread, and cracker products	68.1	Jewelry	4.0
Beef and veal	61.1	Public transportation between cities excl. airlines	2.7
Fresh sweetrolls, coffeecakes, doughnuts	59.6	Infants' and toddlers' apparel	1.6
Fresh cakes & cupcakes	59.2	Men's suits, sport coats, & outerwear	0.4
Soups	57.9	Laundry appliances	0.0
Frozen and refrigerated bakery products ..	57.8	Women's outerwear	-3.5
Potatoes	57.7	Men's footwear	-3.5
Rent of primary residence	57.6	Girls' apparel	-4.0
Motor oil, coolant, & fluids	55.9	Men's pants & shorts	-4.6
Newspapers, magazines, books	53.5	Haircuts and other personal care services	-5.9
Postage	52.6	Boys' apparel	-8.8
All-items CPI	51.3	Sports equipment	-10.2
Fresh whole milk	49.0	Clocks, lamps, and decorator items	-16.8
Cookies	48.1	Women's dresses	-18.2
Motor vehicle maintenance & repair	46.1	Photographic equipment & supplies	-20.5
Food away from home	46.0	Long distance in-state phone calls	-27.4
Beer & ale at home	45.7	Long distance out-of-state phone calls	-28.7
Distilled spirits at home	44.6	Toys	-29.0
Cheese & related products	44.2	Audio equipment	-31.6
Poultry	43.5	Televisions	-62.1
Ice cream & related products	43.1	Personal computers & other information processing equipment	-84.7
Spices, seasonings, condiments, sauces ...	42.9		
Ham	41.0		

extent, by the freeing of time formerly spent waiting in line and a greater selection of goods and services. Similarly, in the United States, when the government removed price controls on petroleum in the 1970s, the gas lines disappeared.

Be that as it may, the larger point to be gained from the table is simple: no matter what the politicians and monetary authorities say, the buying power of the dollar continues to sink. Chronic price inflation even at “moderate” rates leads to substan-

tial losses of buying power over time. In 1978, Federal legislation first explicitly directed the Federal Reserve to conduct monetary policy with a goal that included ‘stable prices.’ Yet the CPI has almost tripled since then, suggesting that the purchasing power of the dollar has been cut by almost two-thirds since the Federal Reserve was first directed to pursue ‘stable prices.’ How much more purchasing power will our money lose in the years ahead? □

