

The AIER Cost-of-Living Guide

Price inflation accelerated in 2005. The Consumer Price Index (CPI) increased by 3.8 percent in the first 11 months of the year, compared with 3.3 percent in all of 2004 and just 1.8 percent the year before that. For the second straight year, rising energy prices led the increase.

The CPI has now increased every year since 1955. Looking further back, the purchasing power of the dollar has fallen by almost 95 percent since 1913. That's the same year that Congress created the Federal Reserve System, which, as the Nation's central bank, is 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. Fiat currencies derive their value solely from a government "fiat," or decree, that they are legal tender.

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 market 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.

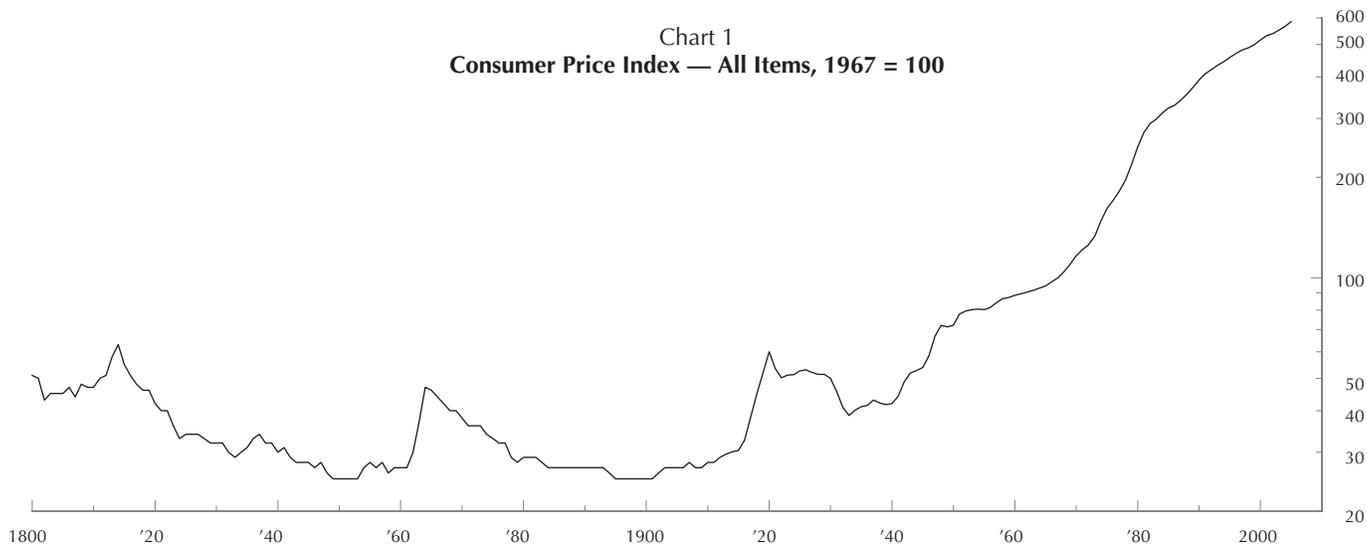
During each of those episodes when the dollar's purchasing power plunged, the currency's redeemability into monetary commodities (gold or silver) at fixed rates was impaired. After convertibility was restored, prices began to return to their prior levels. From the perspective of modern experience, it 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

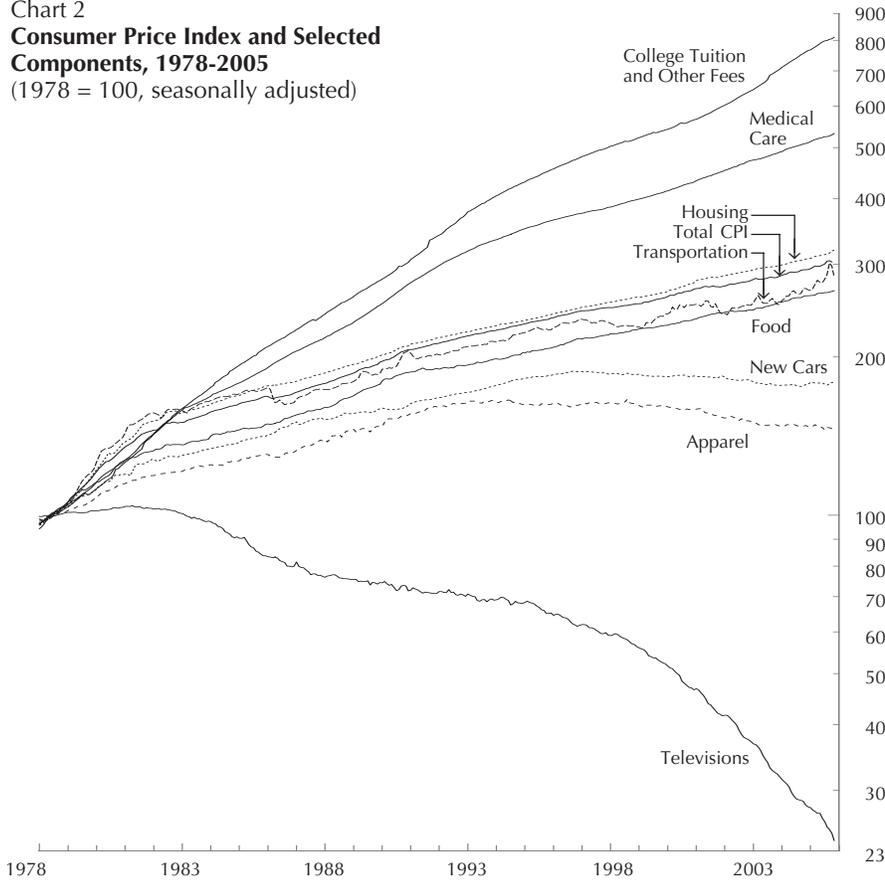
There is, of course, no such thing as a "general price level." Price indexes attempt to summarize the prices paid by millions of different individuals for the myriad goods and services produced in the overall economy. The CPI, the most widely used barometer of overall price inflation, was developed during World War I, when the unprecedented economic mobilization that was undertaken to meet

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, 1978-2005
 (1978 = 100, seasonally adjusted)



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 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 Census Bureau does this by surveying consumers. The survey currently used is believed to represent the spending habits of about 85 percent of the population. The price inflation experienced by the other 15 percent—mainly persons living in rural areas—may not be accurately measured by the CPI.

Hundreds of 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 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 Bureau of Labor Statistics, 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.

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.

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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 comparatively 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 2005. An eclectic mix of services and commodities lead the list, including educational and medical care services as well as energy products, cigarettes, and oranges. At the other extreme, the prices of (constant quality) personal computers and other information-processing equipment have plummeted by 85 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 2005 hurricanes were a factor behind the recent surge in energy 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 large subsidies for education and health care have increased demand for them and thereby helped push prices upward. 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

PERCENT CHANGES IN SELECTED PRICE INDEXES

1990 — 2005

<i>Item</i>	<i>% Change</i>	<i>Item</i>	<i>% Change</i>
Cigarettes & other tobacco products	197.4	Distilled spirits at home	45.9
College tuition and fees	191.3	Ham	45.8
Oranges & tangerines	181.0	Cheese & related products	45.6
Elementary & high school tuition & fees ...	180.6	Telephone services, local charges	44.8
Utility natural gas service	173.9	Ice cream & related products	43.5
Household fuel oil	171.0	Fish & seafood	42.7
Hospital services, nursing homes, adult day care	167.8	Snack foods	42.7
Gasoline (all types)	132.3	Coffee	42.4
Cable television	128.5	Frozen vegetables	41.9
Educational books & supplies	127.8	Wine at home	40.2
Housing at school, excluding board	120.9	Margarine	39.2
Dental services	119.4	Pork chops	38.4
Bank services, tax return preparation, other financial services	115.5	Rice, pasta, cornmeal	37.6
Tomatoes	113.1	Sugar & sweets	37.5
Legal services	108.7	Bananas	36.9
Prescription drugs & medical supplies	106.5	Electricity	36.2
Funeral expenses	104.9	Nonprescription medical equipment & supplies	35.8
Apples	99.7	Breakfast cereal	32.2
Garbage & trash collection	99.0	Housekeeping supplies	30.9
Water & sewerage maintenance	98.8	Nonprescription (over-the-counter) drugs ..	28.3
Bacon & related products	96.7	Pets & pet products	27.5
Out of town lodging, incl. hotels & motels	95.8	Stationery supplies & gift wrap	27.4
Admissions to movies, theater, sporting events, etc.	94.7	Shampoo, cosmetics, perfume, & other personal care products	24.3
Motor vehicle insurance	93.5	Carbonated drinks	20.4
Fees for lessons or instructions	93.3	New trucks	19.6
Lettuce	90.5	Sports vehicles including bicycles	18.9
Physicians' services	88.2	Frozen & freeze dried prepared foods	17.7
Lamb & organ meats	85.9	Used cars & trucks	16.5
Bread other than white	83.9	Women's footwear	16.2
Potatoes	81.1	New cars	11.7
Airline fare	78.6	Vehicle parts & equipment other than tires	11.3
Public transportation within city	77.0	Eggs	10.8
Motor oil, coolant, & fluids	76.6	Furniture & bedding	10.7
Alcoholic beverages away from home	76.5	Public transportation between cities excl. airlines	7.3
White bread	76.3	Tires	6.8
Butter	71.9	Watches	6.0
Motor vehicle maintenance & repair	65.9	Boys' and girls' footwear	5.5
Crackers, bread, and cracker products	65.7	Laundry appliances	4.7
Beef and veal	63.1	Men's suits, sport coats, & outerwear	3.9
Fresh sweetrolls, coffeecakes, doughnuts	62.9	Jewelry	3.9
Rent of primary residence	62.4	Infants' and toddlers' apparel	0.0
Fresh cakes & cupcakes	62.2	Men's footwear	-0.3
Haircuts and personal care services	58.2	Women's outerwear	-0.4
Soups	58.0	Men's pants & shorts	-5.7
All-items CPI	56.3	Girls' apparel	-8.6
Frozen and refrigerated bakery products ..	55.8	Women's dresses	-9.6
Newspapers, magazines, books	53.7	Sports equipment	-11.2
Fresh whole milk	52.9	Boys' apparel	-13.7
Postage	52.6	Photographic equipment & supplies	-23.6
Food away from home	50.7	Clocks, lamps, and decorator items	-24.0
Cookies	50.6	Long distance in-state phone calls	-27.4
Frankfurters	48.2	Long distance out-of-state phone calls	-31.1
Spices, seasonings, condiments, sauces ...	47.9	Toys	-33.4
Beer & ale at home	47.3	Audio equipment	-37.5
Poultry	46.8	Televisions	-67.7
Eyeglasses & eye care	46.2	Personal computers & other information processing equipment	-85.9

higher prices are offset, at least to some 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 substantial 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 tripled since then, suggesting that the purchasing power of the dollar has been cut by 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? □

