

## Mitchell's Musings 8-11-14: What's Cooking?

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A few weeks ago, *Los Angeles Times* columnist Michael Hiltzik ran a piece entitled "A new right-wing claim: Obama must be lying about inflation!" which was about a new conspiracy theory concerning government price change data.<sup>1</sup> The theme, as the headline suggests, is that some folks believe that the official inflation statistics are being kept too low, i.e., the books are being cooked. So let's look at the data and see what the fuss is all about.

Below are June-to-June annual inflation rates (June is the latest month available at this writing) for the Consumer Price Index (CPI) for all urban workers (CPI-U). As can be seen from the table, since the Great Recession and its aftermath, inflation has been low by this measure. When you eliminate food and energy – the volatile sectors – from the index to get the so-called "core" inflation rate, the same picture overall results. Inflation is low by either measure.

### **June-to-June CPI Annual Inflation Rates**

	2007-8	2008-9	2009-10	2010-11	2011-12	2012-13	2013-14
<b>CPI-U</b>	5.0	-1.4	1.1	3.6	1.7	1.8	2.1
<b>Core-CPI</b>	2.4	1.7	0.9	1.6	2.2	1.6	1.9

**Source: U.S. Bureau of Labor Statistics.**

Now you might think low inflation is what might be expected when the economy is soft and, therefore, price raising is difficult. And you might think – based on the headline – that the notion that the price books are being cooked is just "politics" from folks who don't like Obama. But the story is a bit more complicated.

Let's start with the notion of an inflation-data conspiracy and what that might mean. One definition might be that someone nefariously is simply putting in false raw numbers out of which the overall CPI is made. That is, when the true data come in on the price of bananas, someone erases the true numbers and puts in figures calculated to lower the inflation rate, an outright fraud. Let's just call it "fraud" for simplicity.

Another version of conspiracy involves methodology. The true raw numbers are kept, i.e., the actual price of bananas is entered, but the numbers are then combined and adjusted in ways which reduce the official inflation rate. So let's call that version "methodology" for short. And

<sup>1</sup> <http://www.latimes.com/business/hiltzik/la-fi-mh-lying-about-inflation-20140723-column.html>

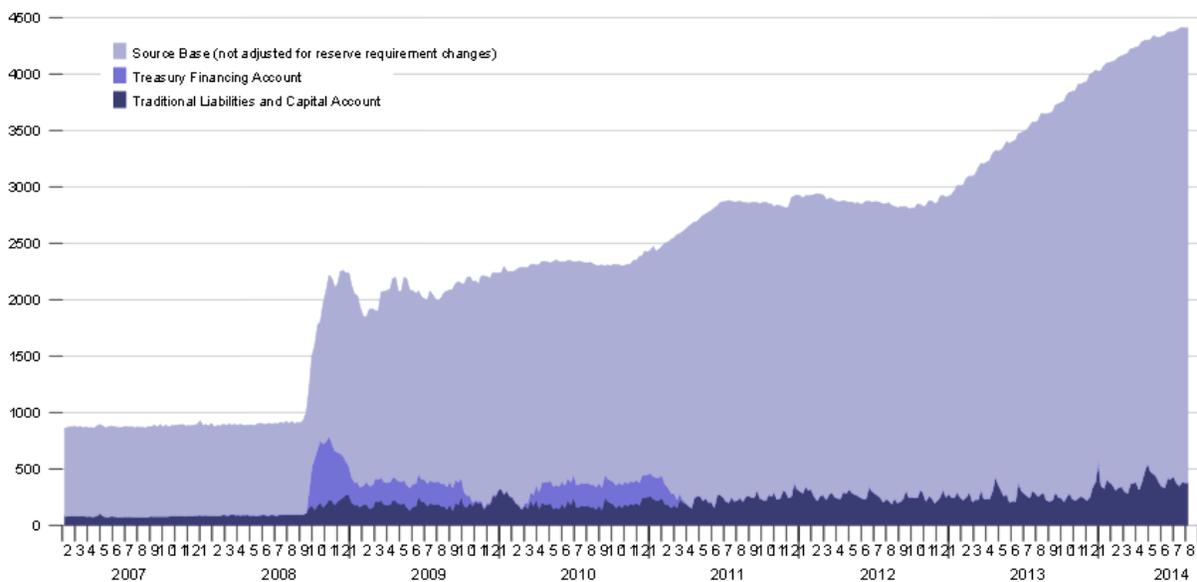
let's also note that in any form of accounting, there are always choices, e.g., FIFO vs. LIFO, that can make the end results look different – but which have some analytic basis.

Let's return now to the Hiltzik story. What is behind the belief that the books are being cooked, apart from the political element? The answer has to do with Federal Reserve policy starting with the Great Recession. Essentially, the Fed has followed an “easy” monetary policy, lowering short-term interests close to zero. It has done so by buying various financial assets. The goal was partly general stimulus to the economy from low interest rates but also to inject “liquidity” into the financial system and avoid disruptive bankruptcies of financial institutions. The Fed buys assets with money it creates which is technically a counteracting liability of the Fed that balances the assets. The chart below shows the large jump in liability of the Fed starting with the financial crisis of 2008.

### Composition of Federal Reserve Liabilities

End of Period Wednesday Figures

Billions of Dollars



It is this money-creating activity of the Fed that gives rise to the conspiracy charge. Versions of the quantity theory of money have been around for a very long time but the notion that money creation is inflationary – “too much money chasing too few goods” – is at the heart of all of them. So if the Fed has been creating money, there should be inflation. If the official figures don't show that inflation, someone must be cooking the books.

The problem is that simple monetarism isn't very helpful in a period of economic softness and changes in the financial system. In the most general sense, money creation is stimulatory. But exactly how stimulatory? Moreover, stimulation could mean enhancing the real level of

economic activity (employment, output) – relative to what it might otherwise be. Or it could be price increasing. While the “Keynesian” models of, say, the 1960s, posed an either/or answer (either real activity or inflation), the empirical evidence suggests you can get a mix of both responses. And, the degree to which you get one or the other responses in the mix seems to vary over time.

The simple fact is that the Fed doesn’t know exactly what the mix is. Therefore, it is proceeding pragmatically. If inflation were to arise, it would pull back. So far, the inflation that would warrant a pulling back hasn’t happened.<sup>2</sup>

There is an irony in the belief that there must be a conspiracy hiding true inflation because theory suggests (to some) that Fed policy in recent times surely *must* be causing inflation. The believers don’t specify whether the conspiracy is of the fraud type or the methodology type. With outright fraud, of course, the fraudster gets to pick the results. But methodology manipulation is much more limited.

We have been diddling with CPI methodology, particularly in the 1990s after the Boskin Commission of that era said that the then-CPI was overstating the inflation rate by a bit over a percentage point.<sup>3</sup> Generally, the motive for suddenly examining the CPI and diddling with it at that time came from the right side of the political spectrum. Various public benefits, notably Social Security, are indexed to the CPI. So, if you think those benefits are too generous, coming up with a bunch of methodological critiques and suggestions that have the effect of lowering the official inflation rate will cut those benefits.

But you can’t have it both ways. The official inflation rate cannot be too high for Social Security but too low given Fed policy. Moreover, the Boskin episode showed the limits of diddling with methodology as a way of cutting the official rate of inflation. Dropping it by 1 percentage point or so is the most they could do. If you are a puzzled monetarist today, adding a percent to the CPI inflation rate shown on the table of page 1 isn’t going to do much for you. Inflation should be raging. Saying it is really 3% per annum, not 2%, isn’t nearly enough.

Of course, you instead could say that the Great Inflation may not be present now, but it is surely coming. If that is your view, there is then no point in charging that the books are currently being cooked although I suppose you could charge that someone will cook them in

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<sup>2</sup>A nice portrait of the Fed in the current period and its new chair Janet Yellen can be found in Nicholas Lemann, “The Hand on the Lever: How Janet Yellen is Redefining the Federal Reserve,” *New Yorker*, July 21, 2014, pp. 42-53.

<sup>3</sup><http://www.ssa.gov/history/reports/boskinrpt.html> and <http://www.bls.gov/pir/journal/gj10.pdf>.

the future. The difficulty you will have with a certainty that a roaring inflation is coming is that financial markets don't seem to believe it.

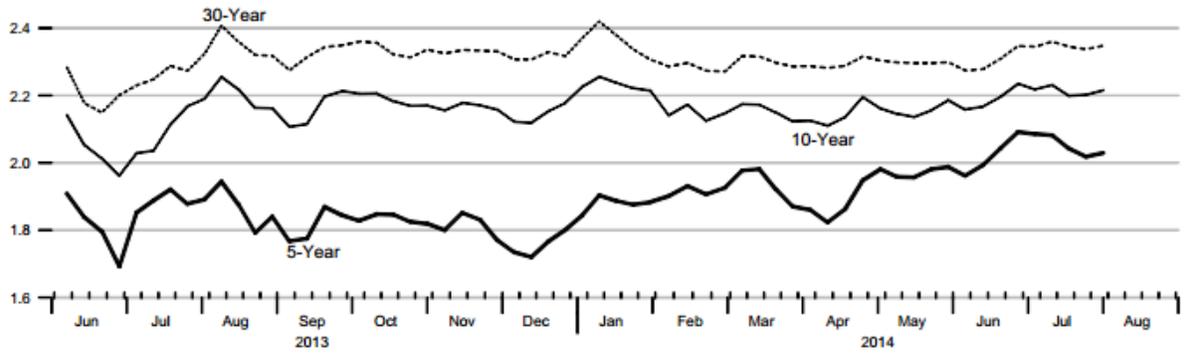
The charts on the next page show the yields on various Treasury securities ranging in maturity from five to thirty years. When yields on inflation-indexed Treasuries are compared with those of conventional Treasuries of the same duration (upper chart), you have a kind of market forecast of inflation. None of the yield spreads show an expectation of raging inflation. Admittedly, the spread is a forecast of the CPI inflation rate which is used in the indexing. So if you think the CPI is already corrupt, or will be corrupt, you might ignore that expectation.

However, you can't ignore the raw yields – lower chart – which have *no* direct CPI connection. You probably believe that long-term nominal yields of the type the lower chart shows reflect both a real return to lenders and an allowance for inflation. Presumably, that allowance for inflation is the “true” inflation rate – whatever you think that is – and not necessarily CPI inflation. With 30-year Treasuries yielding around 3.3% per annum, there isn't a whole lot of room for the “true” expected inflation rate to be very high, no matter how you interpret those yields. So here's the question for inflation conspiracy believers. If inflation isn't high now, and if financial markets don't see it being high in the future, what do you know that no one else does?

## Inflation-Indexed Treasury Yield Spreads

Averages of Daily Figures

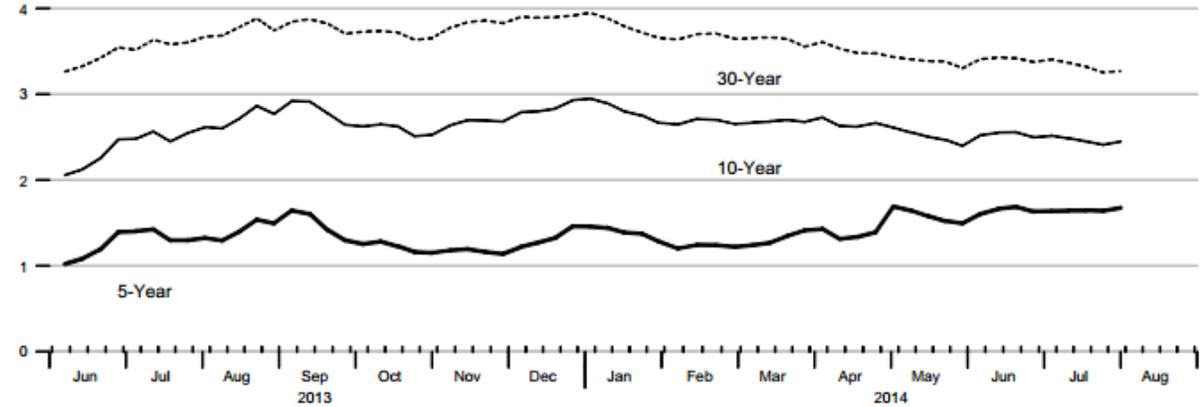
Percent  
2.6



## Treasury Note Yields

Averages of Daily Figures

Percent



Source: Federal Reserve Bank of St. Louis.