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AS A MEASURE OF INFLATION, THE CONSUMER PRICE INDEX FAILS THE TEST

New Study Suggests the CPI Is a Poor Target for Monetary Policy

ANNANDALE-ON-HUDSON, N.Y.--For the central bank's inflation-fighters, the consumer price index (CPI) is considered a key barometer of their success or failure. But as a target for monetary policy and a measure of actual inflation, the CPI fails the test, according to a new study from The Jerome Levy Economics Institute.

In their new Public Policy Brief, ***Targeting Inflation, The Effects of Monetary Policy on the CPI and Its Housing Component,*** Levy Institute Executive Director Dimitri B. Papadimitriou and Research Associate L. Randall Wray show that the CPI is an extremely poor measure of real inflation, not just overstating the inflation rate but misrepresenting it in ways that could prompt monetary policy decisions that might damage the economy and actually increase the CPI.

The authors examine the CPI's components, looking specifically at housing, which is considered to be the component most directly influenced by monetary policy. "Changes in the CPI do not reflect actual market conditions," Papadimitriou contends, "and the components that cause the CPI to rise, primarily those in the service sector, are not likely to be directly affected by monetary policy."

"A large portion of the CPI is composed of "imputed" values that are largely unconnected with market forces that respond directly to monetary policy," Papadimitriou says. The housing component, for example, is based on rental cost surveys and imputed home owners' costs such as the "owners' equivalent rent," or the rent owners could collect on their homes. Since these measures are unlikely to reflect actual changes in the cost of owner-occupied housing, which accounts for 85 percent of the housing sector, the housing component misstates real inflation in the housing market. And since this component now represents more than 40 percent of the CPI, this misstatement can be substantial.

"Tightening monetary policy in response to a rising CPI could actually raise those costs that are measured by the index's housing component, perversely increasing the CPI and igniting a vicious cycle of interest rate hikes, depression of the market for single-family detached

homes, and increases in rents and imputed rents," which would then further drive up the CPI, according to Wray.

"If the CPI shows inflationary pressures in large components over which the Fed has little control, and the Fed attempts to offset these pressures by causing price deflation in the remaining components, monetary policy could become so tight as to cause substantial disruptions and even long-run harm to the economy," the authors say. "Aside from the question of whether price stability should be Federal Reserve's primary goal, these findings raise serious doubts about using the CPI as a gauge of inflation in setting monetary policy."

Public Policy Brief No. 27, ***Targeting Inflation,*** *The Effects of Monetary Policy on the CPI and Its Housing Component,* 1996

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