

Inflation May Be Worse Than We Think

By DAVID RANSON

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Amid Wall Street's recession panic, the latest official inflation news has received less attention than usual. The "headline" consumer price index (CPI) for the year ending in January was up 4.3%, the third consecutive monthly reading above 4%. This has been easy to attribute to rising energy costs, for which the blame is often misplaced on foreigners and oil companies. But as I've argued on this page in the past, the real problem is the sick dollar.

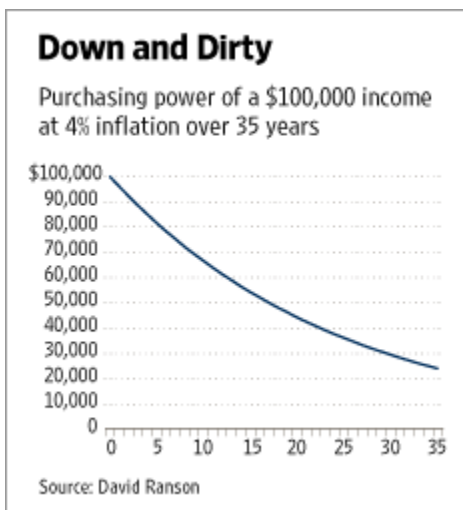
The "core" CPI that excludes energy and food shows a 12-month rise of 2.5%. Though higher than the Federal Reserve's so-called comfort zone, that's not yet dramatic enough to dominate the headlines -- or to hold the Fed back from responding to the pain that its primary constituency, the banking community, is going through. Reinforced by intense pressure from Congress, the banking panic has compelled the Fed to take its eye off inflation. Rates have been reduced by more than two percentage points, and more cuts are expected.

While the practice of excluding energy and food costs to glimpse the "underlying" rate of inflation meets a lot of skepticism, the official consumer-price picture still keeps everyone guessing. The root of the confusion is the fact that the prices consumers actually pay change far more quickly than the CPI.

The CPI utilizes what is, in effect, a form of historical cost accounting. Its shelter component, which carries the greatest weight, is designed to reflect the average monthly cost to households who moved into their living space at a wide range of times dating many years back in the past. Other components are based on price "menus" published by retailers or fees set by public authorities, neither of which changes frequently. In the financial markets, only prices from recent transactions would provide timely information. But government agencies are comfortable with cheaper and backward-looking data.

The most timely figures come from the commodity markets, where prices are transparent and reflect conditions in the immediate present. Yet commentators tend to discount volatile data like energy and food prices when they assess the "underlying" rate of inflation. This is a big mistake.

Markets look forward, while government surveys of the cost of living are a rearview mirror. A little "indicator analysis" shows that commodity prices, far from reverting quickly back to the mean, are early-warning indicators of the future CPI. Last year's large increases in energy and food imply that consumer-price inflation is going to be much closer to today's "headline" rate of 4.3% than the "core" rate of 2.5%.



Why does this matter? The accompanying graph shows how rapidly the purchasing power of income declines from an ongoing inflation of 4%. After nine years, an income of \$100,000 is worth only \$70,000. After 17 years its purchasing power has been cut in half, and after 30 years by about 70%.

The cumulative loss of purchasing power if inflation persists above 4% is an awesome prospect that is surely going to be unacceptable. When the Fed gets its eye back on the inflation ball, a return to higher interest rates will not be far behind.

But worse may be yet to come. While commodities like energy and food are leading indicators of the CPI, precious metals like gold are, in turn,

leading indicators of energy and food. It's sobering to note that precious-metals prices this year are running more than 30% ahead of where they were a year ago. The situation evokes one of Johnny Cash's songs, "Five Feet High and Rising."

Historically, CPI inflation is more closely related to prior changes in the price of gold than most people realize. The correlation is obscured by great differences in short-term behavior -- the price of gold is notoriously volatile, while the CPI is very slow-moving. It's therefore necessary to take account of gold-price changes over a multi-year time frame.

There is a remarkable parallel between annual CPI inflation and the cumulative change in the price of gold measured from eight years before. A similar graph could be plotted for silver, and the parallel can also be seen in cross-section by comparing countries over time with varying degrees of currency instability.

Historical CPI data in the U.S. are complicated by occasional changes in the methodology the government uses to calculate the index. In the late 1990s, one of these changes reduced the reported inflation rate significantly. But taken as a whole, the relationship suggests my following rule of thumb to estimate CPI inflation at any time: Divide the percentage change in the gold price from eight years in the past by 80, and add three. This rule of thumb has largely worked over the past several decades. In the last eight years the price of gold has risen 225%. The rule therefore comes out with an answer that puts inflation a lot closer to 6% than 4%.

Commodity prices provide what may be the most pertinent information for anticipating how high CPI inflation is going to get. Even if the gold boom suddenly ends, which I doubt it will, 4% inflation looks very much on the low side. Higher ground, anyone?

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