ADA Economics
Effective analysis to manage financial risk

INFLATION: What we measure & what we miss

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IMPORTANT THINGS ABOUT THE INFLATION RATE

What's in CPI?

The consumer price index (CPI) methodology does not fully capture the evolution in the cost of living these days. These are some important points to be aware of:

I. In Europe, the cost of housing is very loosely captured in the consumer basket (CPI), so when house prices rise consistently and briskly – as is the case now – the increased cost of housing is underestimated in the inflation rate published

II. Historically, prices of goods and services happened fairly infrequently during the year in countries with moderate inflation rates. There were costs and regulations that limited price changes: for example changes prices would require changing printed catalogues or menus (in the case of restaurants); some countries demanded communications to the authorities on the pricing for the year or restricted sales period to only some weeks in the year. All this is largely inapplicable in the digital age, where prices can change at no cost to the company as many times as needed, sales season is loosely regulated or not at all and more complex pricing structures allow for de facto price increases in a non obvious way. This means that the CPI methodology probably is on average underestimating upward price adjustments in our view.

What's in CPI?

III. Historically the average usable life of goods was long – sometimes very long. Think about buildings that would last decades, machinery that would last a decade or even many, think about kitchen items lasting years, cars, clothing, phones…most items had a usable life of years, if not decades. This meant that the frequency of replacement was not an issue of inflation other than the price of the new item. However, shortening the usable life (depreciation) of items is increasingly a critical issue, not just for technology products that have a short life in general, but this is a true for a vast amount of goods and services. That makes depreciation a major source of inflation today and, worse, an unmeasured source of inflation.

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THE IMPLICATION OF QUANTITATIVE EASING ON INFLATION

Inflation channels over time

What is the impact of prolonged quantitative easing on the inflation dynamics of countries over the short and long term?

We have thought long and hard about how to simplify the inflation channels linked to central banks' decisions, with a horizon of up to 10 years. This is what we have come up with. From the shortest lag to the longest, it is useful to think about five inflation channels:

I. Asset prices (almost coincident with monetary stimulus).

II. Commodities and housing inflation (showing quickly after monetary stimulus).

III. The output gap and demand-led inflationary pressures (working with a lag of one-to-three years).

IV. Competition (a broad spectrum that influences the pattern of input prices in the near term, as well as long-term shifts in different sectors).

V. Last but not least, the institutional framework (this works over many years, and it reflects changes in physical constraints, like building a motorway or enhancing agricultural output, as well as ideological shifts, such as changing the central banks' mandate or increasingly sticky inflation expectations).

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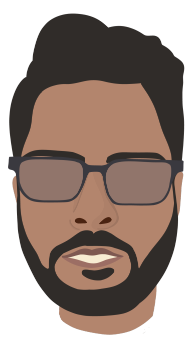

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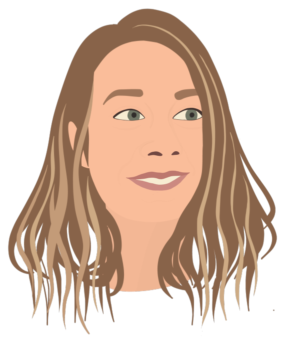

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