

BILL GROSS AND HIS BEEF WITH THE CPI INDEX

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Unless you were out climbing the snow-peaks in the Himalayas, you couldn't have missed this debate. In early October, as we were all watching the buildup to the elections with nervousness, Bill Gross of PIMCO's fame, a UCLA alum (yeah, my school too!) wrote his monthly column titled "Haute Con Job" that was very acerbic. His premise, based on the fashion industry's practice of using good looking models (his example was thin, desirable, gorgeous women) to sell expensive clothes to rich, not-so-lissome ladies, was that Con is the American way of advertising, and it is being foisted on us by the government in the form of low level of inflation produced by hedonic adjustments to the CPI index. (He threw in the car industry's practice of using NASCAR/Indy/Formula 1 cars to sell expensive cars with phony wings to ageing males to avoid the backlash. He from pissed off ladies, just in the

nick-of-lines I would say!)

He opined that a low core inflation number allows us to pretend that US productivity is the best in the world. Low inflation keeps the government's social security payments down. Lower inflation also lets Greenspan keep interest rates low, keeping the stock market up and the housing market rolling, thereby, maintaining his legacy. But what is his biggest beef? He says that the lower than actual calculation of the inflation rate, by as much as 1%, stiffens TIPS holders, and that is a big hit when the 10-year Treasuries are yielding only 4.0%. The additional cost is borne by workers in the form of less than actual wage increases that are based on this cost of living index. Thus, he is raising the flag both for the worker as well as the capitalist class, like a true California Liberal Democrat!

This led to a flurry of responses from both economists as well as some Federal Reserve Bank presidents, leading to rejoinder on October 12th. The issue seems to have died down now as his latest commentary in November focused on elections.

Let me add my two cents here. He criticizes the core inflation concept by arguing that in actuality we do have to pay for food and energy in real life so why strip them out? He is confused between the first-round and second-round effects of inflation as I detailed in the previous section. The FED rightly has to be worried about the second-round effects that show up in core inflation. The core rate is the one that should determine their inflation-fighting rate hikes, and it will also prevent them from making any policy mistakes. Yes, the first-round effects are important and some pain will be there but we are supposed to strategize, substitute and innovate both as consumers and producers. The pain is definitely short-term but not permanent.

On hedonic pricing, his initial argument criticized the methodology for correcting quality improvements and the substitution bias correction in the CPI that results from a change in relative prices. His rejoinder piece backed away from it but left an interesting gem for us to ponder. Yes, he says computer chips are getting better and cheaper as time goes by but when we go out to buy a computer we still have to buy it as a package--chips, hard drive, screen etc.-- which is an improvement but may even end up costing us more. I remember buying

my first laptop seven years ago for two grand, and the latest one cost a little bit more, but is also 10 times more powerful. My cost of maintaining my computing ability actually went up whereas the individual component prices dropped substantially. I as a consumer care only about my cost of computing which determines my other choices in the economy. So hedonic adjustments may accurately reflect productivity increases, which he agrees with, but he argues that they should not be part of a CPI, which is intended to depict the cost of living.

Bill has a point, but guess what folks, there is no perfect solution to this age-old problem, which nowadays has been exacerbated by the rapid pace of technological change. Holders of TIPS (including his firm) may get short-changed but low inflation resulting in lower rates also helps the home-owners and consumers. It eventually balances out because it has to, otherwise we will have a system that will implode. I call this issue as a "tempest in a computer screen", and it was very stimulating during the past month when election politics depressed us all.