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Fed watch: Too consumer price index reliant?

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There has been a great deal of reporting on the federal funds rate, inflation, and the Consumer Price Index (CPI). In short, they are all related in that the mandate for the Federal Reserve Bank is to optimize employment while keeping inflation at bay. As you remember, the new chief of the Federal Reserve Powell entered his job thinking the opposite, suggesting that there would be up to four increases in the Federal Reserve rate during 2019. After both economists and President Trump accused Powell of overreacting, and thus dampening growth, the Fed responded with a more reasoned speech indicating rises in rates were not likely, and that an inflation rate of 2.3% did not warrant a rate increase.

It has been pretty well established that reducing rates "juices" the economy, and with the 2020 election coming up, many would certainly be in favor of this. Since Federal Reserve Chair Powell has indicated that any change in rates would be "data dependent", it is useful to see what data he is talking about. Generally speaking, inflation and deflation are measured by the CPI, although there are other alternative methods as well as significant controversy over how and why this is done. Economists will argue about this in ways that most of us don't understand. I'll give you the basics, since any changes in Federal Funds rates will certainly impact real estate, the primary reason for writing about this at all.

First, there are eight major groups of the Consumer Price Index, including housing, food and beverage, medical care, education and communication, transportation, clothing, recreation and other goods. Each of these categories is weighted, based on importance with regard to the cost of living, and the CPI is established based on a weighted formula. Currently, inflation is running approximately 2.3%. The question you might ask is, if some costs such as housing and education, are so clearly in the news as unaffordable, with more than significant inflation than 2.3% per year, how is such a low CPI possible?

This is where it gets very complicated. Taking the housing example, while housing is theoretically included, it is measured more on rental costs, rather than on actual pricing of housing. The logic behind the decision not to include real estate prices is that they are not purely the price of something currently consumed. They contain both the value of current housing consumption, but also the capitalized value of future housing consumption. As such, including house prices would make CPI a combination of consumption at different times and therefore unsuitable as a measure at a single point. Confusing enough? As a result, rents are included in CPI as they are consumed in the current period. Most would say that, if house prices were included in CPI, we would definitely have a higher inflation rate, and thus the correct action might be to increase the prime rate, resulting in increased mortgage rates, which would dampen house purchases and pricing.

Conceptually, in our everyday living, it seems that the costs of housing, education, and some of the other categories are increasing beyond the rate of our salary growth. Yet, the Fed is able to say that there is minimal inflation, and therefore flat interest rates or even decreases are still needed to maintain a strong economy. Clearly this is great for real estate, and has fueled a ten year plus growth in production and value. Yes, it may have also fueled a bubble. A bubble may lose some air, or even pop, leading to oversupply combined with weakening demand, and thus flattening or decreasing prices. While this may be good as a societal by-product, it may leave some of us real estaters in a difficult position. So far, things still seem to be in balance. Let’s hope the Fed makes appropriate decisions to keep it that way.

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