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January 1997
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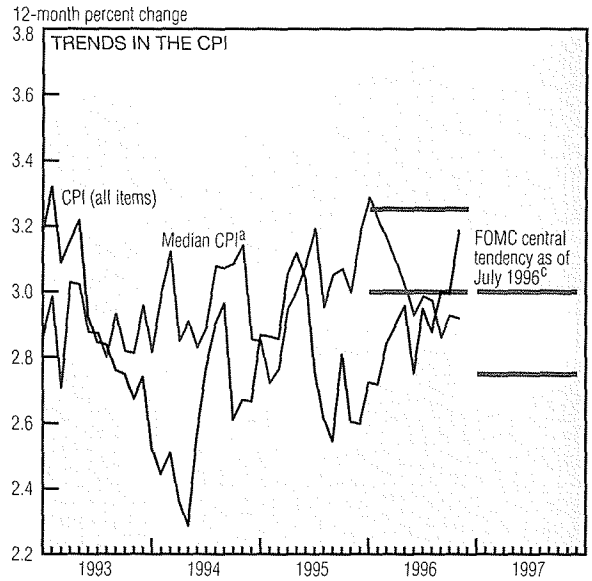
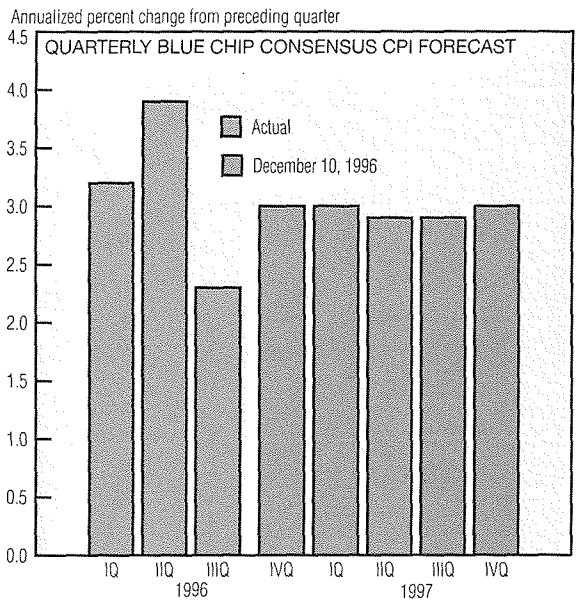
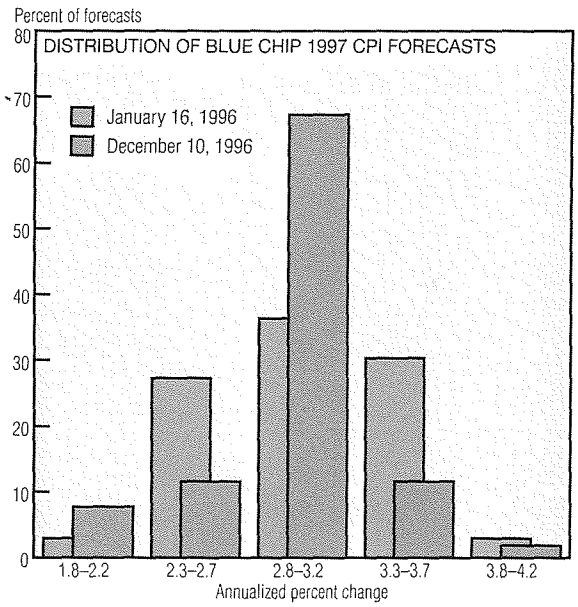
Inflation and Prices

November Price Statistics

	Annualized percent change, last: 1 mo.	6 mo.	12 mo.	5 yr.	1995 avg.
Consumer Prices					
All items	3.1	2.6	3.2	2.8	2.6
Less food and energy	2.2	2.6	2.6	3.0	3.0
Median[a]	2.8	2.8	2.9	3.0	3.2
Producer Prices					
Finished goods	4.6	2.8	3.1	1.6	2.1
Less food and energy	1.7	0.8	0.6	1.4	2.6
Commodity futures prices[b]	–12.1	–12.0	–0.3	2.4	5.4







a. Calculated by the Federal Reserve Bank of Cleveland.
b. As measured by the KR–CRB composite futures index, all commodities. Data reprinted with permission of the Commodity Research Bureau, a Knight-Ridder Business Information Service.
c. Upper and lower bounds for CPI inflation path as implied by the central tendency growth ranges issued by the FOMC and nonvoting Reserve Bank presidents.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; the Federal Reserve Bank of Cleveland; the Commodity Research Bureau; and *Blue Chip Economic Indicators,* January 16 and December 10, 1996.

The Consumer Price Index (CPI) rose 3.1% in November, just a bit under its average increase of the last 12 months. The median CPI, a measure of core inflation, advanced at a slightly slower pace.

Neither economists nor policymakers foresee the CPI's growth rate changing much between 1996 and 1997. At its July meeting, the Federal Open Market Committee projected that the index would rise between 2¾% and 3% this year, not much different from the 2.8% to 3.2% range anticipated by more than 65% of the economists responding to December's Blue Chip survey.

Recently, a fair amount of controversy has surfaced over the CPI's ability to accurately measure changes in the average cost of living. The major measurement problems underlying the index have been reasonably well understood since the first "fixed market basket" indexes were constructed. However, because the CPI is the basis for adjusting roughly one-third of all federal expenditures, CPI "bias" has recently prompted a more focused discussion of "correcting" the index in order to ease the federal government's fiscal problems.

A recent report to the Senate Finance Committee (produced by the Advisory Commission to Study the Consumer Price Index) puts the total annual CPI bias at 1.1%. The components of this bias are believed to be changes in the market basket due to relative price changes (substitution bias, 0.4%), changes in the quality of goods or the introduction of new ones (0.6%), and changes in where goods are purchased (outlet bias, 0.1%).

(continued on next page)

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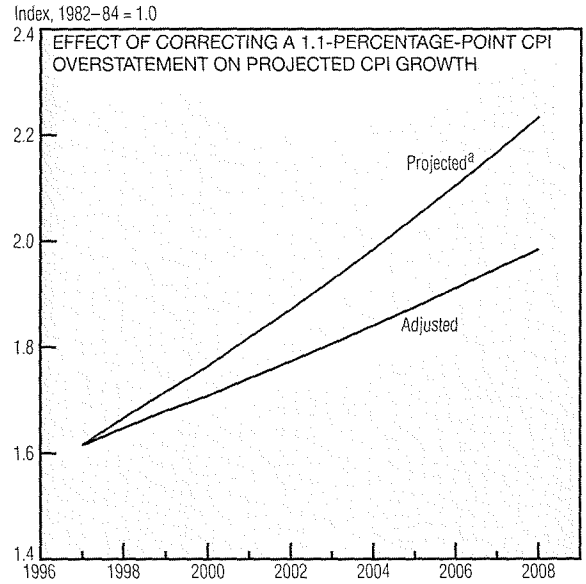
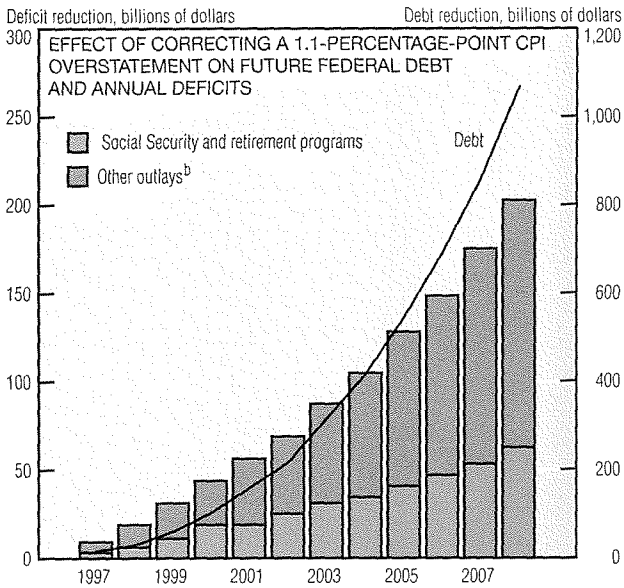
Inflation and Prices (cont.)

Estimates of Annual CPI Bias
(Percentage points)

Senate Advisory Commission	
Substitution bias	0.4
New product/quality change	0.6
Outlet bias	0.1
Total bias	1.1
Range of plausible estimates	0.8 to 1.6
Consensus view of economists*	0.8

* Blue Chip panel of economists, July 10, 1995.





Estimates of Annual New Products/ Quality Bias, by Selected Component[c]

Component	Weight (percent)	Bias (percentage points)
Fresh fruits/vegetables	1.3	0.60 (1967–96)
Appliances	0.8	3.6 (1973–94) 5.6 (1994–96)
Apparel and upkeep	5.5	−0.95 (1965–85) 1.00 (1985–96)
New vehicles	5.0	0.00 (1970–83) 0.59 (1983–96)
Public transportation	1.5	2.66 (1972–77) 4.60 (1977–82) 0.00 (1982–96)
Professional medical and hospital services	5.7	3.00

a. Consensus forecast of the Blue Chip panel of economists, October 10, 1996.
b. Includes reduction in deficits due to revenues, change in debt service, and other outlays.
c. Dates in parentheses represent estimation period.
SOURCES: *Toward a More Accurate Measure of the Cost of Living*, final report to the Senate Finance Committee from the Advisory Commission to Study the Consumer Price Index, Michael J. Boskin, Chairman; and *Blue Chip Economic Indicators*, July 10, 1995 and October 10, 1996.

While the overall bias seems small, its impact on the CPI could be huge if accumulated over several years. If we adjust the CPI's projected growth rate downward by the Commission's bias estimate, the index rises about one-third less than what is currently projected by economists. According to the Congressional Budget Office, a potential overstatement of this magnitude would cause the federal government to exceed its budget by about $200 billion in the year 2008, cumulatively adding more than $1 trillion to federal government debt over the 11-year period.

The Commission's report has received a certain amount of criticism and, at the very least, should be considered speculative. The potentially largest bias in the index comes from mismeasurement of quality changes and the introduction of new goods, areas that economists have identified as having the potential to cause inaccuracies, but for which very little broad-based evidence has been collected. In its report, the Commission indicated wide variation in the amount of quality bias by component. However, these estimates can change sharply from period to period and may, in certain cases, be negative.

For the moment, the Bureau of Labor Statistics (the government agency that oversees the construction of the CPI) is unlikely to make any substantial changes in the index. Besides its use as a federal budget escalator, the CPI is used in labor and other private contracts covering millions of workers. Making permanent alterations without thoroughly understanding their implications could create more problems than it solves.