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Inflation as People Experience It and as Economists Measure It

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Suppose that the average amount that people paid for their rent or mortgage fell by 10 percent, but our index for shelter costs in the Consumer Price Index (CPI) jumped by the same amount. That may sound nutty, but given the way we measure inflation, that sort of story is possible, even if the size of the difference is unlikely to be this extreme.

Inflation, as economists measure it, often differs a great deal from what most people would perceive as their cost of living. As we are entering unusual times with the recovery from the pandemic, it is worth getting a better sense of what these differences are, since they are likely to be important in how we view economic data in the months ahead.

Housing Inflation – It's Not What You Pay

To start with the housing case, it is important to realize that the cost of housing in our price indices measures the change in the rent paid on the same house. This matters because it means that if people move to lower priced housing, that does not show up in the CPI or other price indices as a reduction in the cost of housing.

To take my own case as an example, a few years ago I moved from a house in Washington, DC, to a house in Southern Utah. The house we bought in Utah cost less than one-third of the price for which we sold our house in Washington, yet is somewhat larger and has far more land. This does not get picked up as a decline in housing costs.

In fact, if enough assholes like me move from expensive cities on the East Coast to low-priced areas in the middle of the country, it can actually show up as an increase in housing costs, since we will be driving up prices in the places we move to. There may be some offsetting reduction in prices in Washington and other expensive cities, but there is no reason to think these reductions will necessarily counterbalance the price increases in the interior.

The situation is further complicated by the fact that for owner-occupied housing (a bit less than two-thirds of all units), the indexes use a measure of imputed rent. To get this, the Bureau of Labor Statistics tries to match an owner-occupied unit with an equivalent rental unit. It then assumes that the increase in rents in the equivalent unit corresponds to the rise in implicit rent in the owner-occupied unit – in effect what the owner would be paying if they rented their house.

This measure excludes cost directly related to ownership, most importantly mortgage interest. In the pandemic, tens of millions of homeowners have been able to save thousands of dollars a year by refinancing their mortgages at lower interest rates. These savings are not picked up at all in the CPI or other indices.

The measure of price increases for housing is a big part of the overall inflation picture. The rent and owners' equivalent rent components together account for 32.7 percent of the overall CPI. (More than three quarters is attributable to the owners' equivalent rent component.) They account for more than 41 percent of the core index (excluding food and energy), which economists tend to focus on since it is less volatile.

To date, the inflation rate in the rent indexes have shown relatively little upward movement. The rent proper index (for actual renters) has risen by just 1.9 percent over the last twelve months. The owners' equivalent rent index has gone up by 2.3 percent. Both are considerably below the pre-pandemic rates, which 3.7 percent for rent proper and 3.3 percent for owners' equivalent rent.

It's hard to predict whether rental increases will remain restrained. There has been an enormous increase in house sale prices since the start of the pandemic. This has been driven both by a plunge in mortgage interest rates and the decision by many people to move. Millions more people are now able to work from home, either part of the week or full-time. This means both that they don't have to be close to downtown offices and that they likely need more space to create a comfortable work environment.

It's a bit too early to know whether this trend will lead to large increases in rents nationwide. While increased demand for housing should, other things equal, mean that prices will rise, there are some countervailing factors. First, there has been a huge increase in the construction of new units since the start of the pandemic. We were building new units at the rate of roughly 1.2 million a year before the pandemic. We have been adding housing at a rate of 1.6 million units annually over the last year.

Second, in many areas the housing stock was hugely underutilized. Many smaller cities had large numbers of vacant units, or commercial properties that can easily be converted into residential property. These converted units do not count in our data on housing starts.

Third, we will be ending the federal moratorium on evictions at the end of this month. There were many landlords who found ways around this moratorium, and there are some cities and states that are looking to find ways to protect tenants, but there clearly will be a large number of people facing eviction soon. This is not a good story for these people, but if we are trying to assess the near-term prospects for the housing market, the prospect of several hundred thousand (perhaps well over a million) newly vacant units coming on the market has to have a substantial impact in lowering rents.

To sum up the housing story, I'm not convinced that we will see a sharp rise in rents in the months ahead. The rise in house prices will make it more difficult for renters to become homeowners, due to the large down payments needed. The sharp drop in mortgage interest rates (now averaging close to 3.0 percent for a 30-year mortgage) means that monthly payments in many cases will still be lower than they would have been two years ago for a comparable house. (In other words, this is not a bubble.)

Insofar as we do see increases in our price indexes, it is important to recognize the impact on different groups. For the people moving from expensive cities to cheaper places, it will look like a decline in housing costs. For the homeowners in the cheaper places who see prices driven up by newcomers, it will mean a rise in their house price. That doesn't help if you're not selling. Nor does it help if you sell but the place you buy has gone up by a similar amount, but these people are not especially hurt by the increase in prices.

The one group that is hurt are tenants who must pay more in rent. This is a group that is younger and poorer on average. For them, higher inflation in rents is not a good story.

Commuting Costs

I wanted to take a moment to comment on commuting costs because the way these appear in our price indices bear little relationship to how people experience them. With few exceptions, people do not enjoy their commute. The money (and time) spent commuting are a necessary cost of working. This means that for most people the total amount they spend on commuting and related expenses (e.g. dry cleaning, business clothes, work lunches) are a cost, they don't care about the expense of individual items.

For example, if busses increased their fares by 50 percent, but people only had to travel to work half as much, they would be saving a large amount of money on their commutes. But our price indices would only pick up the fare increase, there would be no accounting of the reduced need for commuting.

I have written on this point before. Insofar as many more people are now able to work largely or entirely from home, this will be a gain in living standards that will not be picked up in conventional measures of GDP. If the individual components of commuting costs rise in price, but people are able to spend less money in total on commuting due to fewer commutes, we would be recording this as a rise in the cost of living, even though people are actually saving money and time on their commutes.

We will have to see the extent to which the increased opportunities to work from home will endure once the pandemic has ended, but it is virtually certain that several million more people will have this option.[1] This opportunity is a really big deal for them.[2]

Health care

The measure of health care inflation in our price indices is likely to bear almost no relation to how people perceive health care costs. The indices look to measure the price of individual products or treatments, not what people are spending on health care costs. To take the case where the difference is probably clearest, the indices measuring drug prices measure the pricing of existing drugs. The prices of new drugs do not affect the index at all.

This would mean, for example, if most doctors recommended that their patients switch to a new and very expensive medication for lowering blood pressure, the higher cost of this drug compared to the previous drug, would never appear in the index. In fact, if the introduction of this new drug led to a fall in the price of the older drugs, the index would show a decline in the price of heart medications, even though most people were actually paying out more money.

We are actually seeing this sort of story with drug prices now. The CPI shows that prescription drug prices fell by 2.5 percent between June of 2020 and June of 2021. Yet, we spent 2.7 percent more on prescription drugs in May of this year than in May of 2020. (We don't have June spending data yet.)

With health care people are likely to care about the total amount they spend and the state of their health, the fact that they spend more or less on a specific item is not going to be of much concern. This is especially true since most people have little direct knowledge of the value of specific drugs or procedures, but rather rely on the recommendation of their doctors.

Spending on health care actually has fallen sharply in the pandemic. In the first quarter of 2021, spending on health care services, which accounts for more than 80 percent of total spending, was 1.4 percent lower than in the fourth quarter of 2019. Clearly, much of this drop was due to people deferring procedures because of the pandemic, however some of this drop may reflect savings due to the increased use of telemedicine instead of in person doctor visits. We will need more time to see whether this slowing continues, but the savings from telemedicine is another gain that will not show up in the CPI.

Food Price and Global Warming

There actually is nothing especially unusual about how food prices are measured, and global warming doesn't change the basic story. However, it is important to point out that higher prices that we will likely see for many products are due to the effects of global warming. Just to take one that has gotten some attention recent, it seems that much of the blueberry crop in the Northwest was destroyed by the extraordinary heat wave the region experienced earlier in this summer.

We are likely to see many cases where crops fail due to excessive heat, droughts, flooding or other climate change related weather events. It will be important to point out the cause, when we see price increases as a result. We can take it as a given that Republican politicians will be screaming bloody murder in response to price increase of any food product, or anything else. It will be important to point out these increases are their work, as the primary supporters of global warming. (I know plenty of Dems have been complicit, but the Republicans have ensured that almost nothing got done over the last quarter century.)

Inflation and Well-Being

We all know that economic measures cannot fully capture the state of people's well-being. A big part of that picture is the inadequacy of the CPI as a measure of the cost of living in any real sense. If people find they can live in a cheaper town or city, and be every bit as happy or even happier, this is a gain not picked up in the CPI. Similarly, money saved on work related commuting expenses are also not picked up.

These, and other issues, are taking special importance now as millions of people are likely to qualitatively change their way of life in response to the pandemic. This is a big deal, and our standard economic measures of GDP and real income will not capture it.

Notes.

[1] In the June Current Population Survey, more than 22 million people reported they worked from home ate least part of the month due to the pandemic.

[2] I realize that not everyone likes working from home. There will be a sorting process where these people look for jobs where they are expected to be physically present, while others seek out jobs that allow them to work from home. This doesn't mean that everyone will be able to get the work arrangement they prefer, but we will almost certainly end up with more workers being satisfied with their situation than before the pandemic.

This first appeared on Dean Baker's Beat the Press blog.

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