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What is Measured?

By Richard W. Rahn
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Do you think inflation is rising faster than the government says (an annualized of 4.1 percent in December)? Many people do, because they are keenly aware of supermarket and gas station prices, but that is not the whole story.

Inflation is defined as an overall increase in the price level, but the "inflation" that each individual faces is different. Over the last year, there has been a big jump in the price of gasoline and in many foods, such as milk and bread. (The increase in food prices is almost entirely due to the government"s foolish policy to subsidize corn for ethanol, thereby driving up the price of not only corn, but every crop that competes with corn for field space.)

However, if a person spends a lot of money on electronic items and communications, and does not drive much, his or her total expenditures might have declined as a result of the continuing rapid drop in prices of most electronic items and communications.

If you bought a Blackberry or Apple iPhone, you purchased an item that can replace your computer for Internet and e-mail access, cell phone, Rolodex and calendar, camera, calculator, global positioning navigator, personal music and video player, etc. To replicate all the things you now get in one Blackberry or iPhone would have cost you many thousands of dollars even a decade ago (even if available).

In the late 1990s and the early in this decade, inflation as reported by the government was quite low, though asset prices, such as homes in many areas, were rising at double digit rates. Now prices of homes and HD flat-screen TVs are falling.

Government economists and statisticians responsible for measuring inflation do not have an easy task, which is only getting more difficult. As the rate of technology change increases, the goods and services we consume radically change, so historical measures become less and less relevant. Yes, bread and milk prices have not changed much, but as people become more affluent, the portion of income they spend on such staples becomes smaller and smaller.

At the same time, the Internet, which for most people is only a decade-old, has caused prices to drop for millions of items — most information now is almost free as are international phone calls using Skype and its competitors.

If inflation becomes more and more difficult to measure, how can central bankers determine how much money to produce to keep a stable price level?

Some call for a return to the gold standard, but that is not the panacea some may think. Gold prices over the last three decades have swung back and forth between $250 and the current $900 per ounce. Sales of gold by governments, as well as global market psychology, can cause substantial price shifts; and the additions to the gold supply each year tend to be less than the potential increase in global GDP, which can have a deflationary effect. Despite these problems, gold may be better than some other alternatives.

For readers desiring a more in-depth, but clearly written and brief discussion of the pros and cons of alternative money systems, I highly recommend a new book with the off-putting title, "One Currency for Bosnia," by Warren Coats. Mr. Coats is a highly regarded monetary economist who has specialized in setting up new monetary and banking systems for countries whose economic systems have collapsed because of war or revolution (i.e., Bosnia-Herzegovina, Iraq, Afghanistan, many of the former communist republics, et al.).

The book is a riveting tale of how Mr. Coats and his International Monetary Fund teams have quite literally risked their lives to help rebuild the economies of war-torn countries. And it is also a wonderful and easy to understand primer on money and banking, in which key concepts are presented in succinct inserts.

Measuring the value of money and inflation within a national economy is difficult enough; but when it comes to measuring real global price changes, the problem is greatly magnified. Why should the cost of a Big Mac (identical to one in America) be 50 percent more in some European countries, even where their real wages are lower than in the United States?

Why should the value of the euro and the dollar swing more than 60 percent against each other in only five years? These relative currency and price swings wreak havoc with global business people who engage in long-term contracts or build manufacturing operations in several different countries. While the search for a global monetary constant will always remain elusive, there is a need for a more stable reference point than either gold or any national currency can provide.

A highly regarded nongovernmental private organization, with no vested interest (other than enhancing its reputation), could provide a greatly needed service by creating an artificial monetary unit to measure against the price of any good or service on the globe. This unit would need to be a transparent basket index of standard goods and services produced and/or consumed in many countries (the index would evolve over time — like the Dow-Jones stock index — as technologies and global consumption patterns change). Once established, contracts, and even interest-bearing securities, could be written in the monetary unit. Such a widely accepted unit would substantially add to global economic stability and better resource allocation, leading to higher global economic growth.

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