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THE MEASUREMENT PROBLEM

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Should the Fed and the other central banks raise interest rates? A major part of the answer is whether inflation is rising or falling – and how it measures whether a dollar is buying more or less. Over time, some things become relatively more expensive and some things less expensive; for instance, long-distance phone calls.

On average, the experts in the US government have concluded that the dollar buys about 1/25th of what it did in 1914. The price of gasoline tends to be very volatile but has increased roughly with that of the wholesale price index over the last century – so the real price of gasoline has remained about the same. There is a great deal of focus on gasoline price changes in the news, and most drivers are well aware of monthly changes – even though that is not really the information they need.

The relevant information is "what is the fuel cost of moving a typical car one mile?" So, if gasoline prices are stable in real terms, but because of improvements in technology, the amount of fuel required to move the automobile one mile has declined perhaps 50% or more – the dollar is buying more of the relevant product – transportation – than the price index would show. The most popular car in the early 1920s was the Ford Model T. It was small and slow – much more like a modern big golf cart than a full-size Ford sedan of today, yet it took more gasoline to move the 1920 Ford a mile.

The government experts who compile the price statistics are of course aware of product improvements and try to incorporate some of the improvements in their estimates, but it is a near impossible task to do it with any precision.

Automobile deaths are now half the rate per mile driven of only a few decades ago. What is the value we put on each life saved because of safer cars? How do we put those numbers in a price index, even though it is obvious that the effect of fewer deaths is deflationary?

This is not merely an academic exercise because, if the Fed acts incorrectly because of bad data, it can have real effects on employment and economic well-being. The Fed, as it should, pays close attention to the productivity numbers. If employers utilise their capital more effectively, train and motivate their workers better so that the company can increase its output of whatever it makes at a more rapid rate than it invests, and/or hires more workers – it is increasing its productivity. From the standpoint of the Fed, increases in productivity mean that a given amount of money can support a higher level of economic activity. If the Fed gets this number and many other numbers wrong, it is likely to create too much additional money, causing inflation, or too little, causing deflation. What people and business folks want are price stability and certainty.

Many economists and news commentators have been baffled by the fact the US has what appears to be full employment, yet this is not apparently causing inflation – as those who still believe in the long-discredited Phillips Curve think should be occurring. Simply put, the argument is that, if the economy is at full employment, wages would be bid up, causing inflation. But as Milton Friedman and others explained, if the Federal Reserve did not increase the amount of money, wages might rise but other prices would fall. It is ironic to see officials of the Fed worrying about inflation "caused" by full employment when, in fact, only the Fed can cause inflation (a general increase in the price level) by producing too much money.

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Relative prices change all of the time, and the Fed has little control over such relative price changes – the price of chicken may rise while the price of beer falls.

We now have a world where interest rates in the major countries are very low by historical standards, but global government debt is at a record high.

Several very good economists argue that, because of declining birth rates and advances in medical science, the average age of the world's population is rising rapidly – which is particularly evident in the richer countries.

Older people tend to have higher savings rates than younger people. The older generations are well aware of the build-up in government debt and may believe, therefore, that they cannot rely on government pensions. This fact may be inducing them to save more in order to provide for their old age. There is particularly strong evidence from Japan to support this thesis.

Another thing that could be happening is there are much more rapid increases in productivity than is being measured. It was about 140 years ago that Thomas Edison invented what became the standard filament light bulb. Other types of lighting were invented, but the "standard" bulb is just now disappearing. The LED (light emitting diode) is becoming the new standard. It uses about 15% of the electricity for the same amount of light as the old filament bulb, and for all practical purposes it does not wear out – it can go on for many years. In the last couple of years, manufacturers have figured out ways to make it inexpensive despite the very difficult technology involved. The benefits to both rich and poor are enormous; about 17% of all electrical power generation goes for lighting, and now this cost is declining by about 80%. Poor people in places like Africa who did not have electric power and lights now have very inexpensive units using solar cells and LEDs so they and their children can read at night – the total benefit is far greater than what is measured.

The smartphone has done more to lift living standards on the planet than any other single device ever invented – with literally billions of people acquiring one in the last decade. Do a thought experiment – look at your smartphone and all of the aps. Make an estimate of what each of these features would have cost you two decades ago if you had purchased them separately (many of the features could not have been purchased at any price because they and/or the technology did not exist). Only a few extraordinarily wealthy people could have even come close to having the ability to purchase all of what billions now do with their smartphones. The smartphone, in certain sense, has made everyone a millionaire – everyone is rich!

The advances in medical technologies, devices, and procedures are now growing at an exponential rate. A good number of people, many of them highly productive, are now alive but would not have been twenty years ago because of the advances in medical technology.

Famines, except for those induced by evil and corrupt governments, have disappeared from the planet because of the advances in biotech.

The examples are almost limitless. Yet, at the same time, there are people at the Fed and other central banks trying to figure out how to get to 2% inflation – which makes no sense to begin with – while in the real world the dollar (and other major currencies) can now purchase what would have cost millions a few years ago.

The Fed still tries to set interest rates, but the markets are greatly restricting their ability to do so – as was demonstrated with the policy reversal in December 2018. The central banks of the world, by holding interest rates near zero for much of the last decade, caused a huge amount of mal-investment, particularly into residential real estate.

The Fed and the other central banks have an impossible job, which is only getting worse. They do not really know what they are trying to do and why, and their traditional tools have become duller and duller. Some of the wiser senior Fed alumni are now proposing that a commission be established to look at the problem with a clean slate. An institution created out of political compromises more than 10 decades ago has clearly outlived its usefulness.

The American Founders thought one of the functions of the government was to define the dollar (but not necessarily produce them) in terms of one or more commodities, like gold and/or silver, that is legal tender to pay taxes and receive government payments.

The Constitution seems to be a good place to start for any commission looking to develop a reset.

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