

National Economic Trends



Consumer Price Inflation and Housing Prices

When inflation was high, the goal of monetary policy was to make it lower. It did not matter much which index we looked at; they were all rising too quickly. Now, inflation has fallen below 2 percent, and many people think that the goal of monetary policy should be to stabilize inflation at this low rate. Choosing which index to use can now make a difference.

Distinguishing the signal from the noise in any price index is more difficult when the underlying inflation signal is weak. The consumer price index (CPI) and the price deflator for personal consumption expenditures (DPCE) are alternative measures of consumer price inflation. Although there are many reasons why the two indexes may differ, the difference is usually small when averaged over periods as long as two years. But sometimes there is a significant gap. In the period including 1995 and 1996, the CPI rose 2.9 percent while the DPCE rose only 2.1 percent. Then, the major sources of deviation between the CPI and the DPCE were in three items: used cars, auto insurance and homeowner's equivalent rent.¹ (Rather than measuring the cost of home ownership directly, the Bureau of Labor Statistics uses a concept called "owner's equivalent rent." This is the price of rental units from a sample selected to represent the population of owner-occupied homes.)

During the last two years, the CPI has risen at a 1.7 percent rate while the DPCE has risen only 1.0 percent. Most of the difference can be explained as follows: The relative weights on housing in the two indexes are quite different, and the cost of housing has risen more rapidly than other prices during this period. Because the housing prices used in the DPCE are nearly the same as those used in the CPI, the different effects of housing on the two indexes come from the different weights. The share of housing in personal consumer expenditures, as measured by the Bureau of Economic Analysis, is about 14 percent. The share as measured in the 1995

Consumer Expenditure Survey, which underlies the CPI, was about 28 percent. The DPCE weight was smaller partly because PCE, unlike the CPI basket, includes spending by rural households and non-profit institutions.

Inflation in the main part of housing services—rents and rental equivalents—moved very closely with the actual CPI and the DPCE until 1995. During the last two years, housing prices for both homeowners and renters have grown between 3 percent and 4 percent per year, much more quickly than other components of the DPCE and CPI. Housing's greater weight in the CPI leads to a higher overall inflation rate.

The chart below shows the 12-month inflation rate as measured by three indexes: the CPI, the DPCE, and the adjusted DPCE, which gives housing the same relative weight as it has in the CPI. The chart shows that the spread between the CPI and the DPCE has recently been about 3/4 of a percentage point. As you can see, this adjustment had little effect on the difference between the CPI and the DPCE until 1997. Since then, it can account for most of it.

—William T. Gavin

¹ See Fixler, Dennis, and Ted Jaditz, "An Examination of the Difference Between the CPI and the PCE Deflator," Bureau of Labor Statistics, Washington, D. C., January 1997.

DPCE using CPI Housing Weights

Percent change from year ago

