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No true measure for inflation

IT is a well-known and generally accepted phenomenon that newspaper reports on world and sports events vary, or that suspects in detective films give differing accounts on the circumstances of the case.

But the fact that several, by no means identical, figures concerning the rate of inflation in a particular country circulate gives much more cause for astonishment. This amazement is familiar to observers of the American economic scene in particular and often develops into complete puzzlement as far as Europeans are concerned, since conditions on the old continent may be simpler but certainly different.

In Switzerland, as well as in most other European countries, the statistical offices inform the public of the situation on the price front by means of three figures: the index of consumer prices, which reflects the cost of living for representative households, its change in percent from the previous month and its percentage change from the same

month of the preceding year. The latter figure is usually called the official annual rate of inflation.

In the United States, an additional indicator is published in the statistics, the compound annual rate. Its computation alone sometimes causes considerable headache since this rate is established by means of the compound interest formula.

But there is a trace of unreality about the compound rate, since it extrapolates the inflation of the three preceding months to arrive at an annual basis. By projecting the trend into the future, it hypothetically indicates what the annual rate of inflation would be if the inflationary pace of the three preceding months were to persist throughout the year.

The compound rate and the rate of inflation based on a comparison with the previous

year usually differ. In September 1980, for example, the US consumer price index exceeded the previous year's level by 12.7 per cent, while the compound rate stood at only 7 per cent. In October 1980, the compound rate for Switzerland would have amounted to 2.2 per cent, while the rate of inflation computed according to traditional method amounted to 3.6 per cent.

Owing to the differing calculation methods, the two rates of inflation cannot be compared with each other. For this reason, disputes arise repeatedly among economists as to which rate of inflation reflects the true picture. However, since a certain arbitrariness is inherent in each measure applied, practical considerations must play the decisive role.

The main disadvantage in the computation of the rate of inflation according to the

American method is the necessity to exclude seasonal price fluctuations. Despite sophisticated techniques it may therefore happen that a break in the trend, for example owing to a sharp increase in oil prices, is interpreted as a seasonal occurrence and therefore eliminated from the calculation.

In contrast, the European system automatically includes seasonal adjustments, since it always compares the same months of different years, such as the index figure for December 1980 with the figure for December 1979.

The American method's trend towards dramatising events and orientation towards a hypothetical future may be an advantage or a disadvantage, depending on the use the results are put to. Thus the extrapola-

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tion of the actual trends to a year shows especially clearly whether the rate of inflation is accelerating or slowing down.

This magnifying glass effect has a drawback, namely that extraordinary price fluctuations, such as occur owing to a change in sales tax rates, are turned into sensational index movements. However interesting this might be for the analyst or the public, this extreme susceptibility of the inflation-measuring index would only cause confusion if this rate is used as the basis for negotiations between employers and trade unions, for corporate investments or for budget planning or investment decisions.

The observation of inflation with the "naked eye," as practised in Europe, also has a blind spot, namely the so-called base effect. When comparing this year's prices with the ones of the previous year, the speed at which prices are currently changing is not taken into account. It is therefore possible that the *annual* rate of inflation declines over several successive months, even if the increase in prices, as measured by the corresponding monthly inflation rates, accelerates.

An objective and unequivocal measuring of inflation – in the same way the speed of a body can be determined in physics, for example – is not possible because no firm base can be found for the price level index. The choice of the right inflation yardstick among the different methods of calculation must therefore be determined by its expediency.

**Union Bank
of Switzerland**

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