INTEGRA Market Insights

EQUITY Associates Inc.

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Issue #19 - "The Problem with CPI"

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" Americans are getting stronger. Twenty years ago it took two people to carry ten dollars worth of groceries. Today, a five year old can do it."

-Henry Youngman

Although the above quote is somewhat dated, everyone can relate to the meteoric rise in the price of groceries and the general cost of living over the last decade. That being said, government statistics show relatively low rates of inflation. Through Statistics Canada, the government reports the general increase in prices (inflation) through what is known as the Consumer Price Index (CPI) which is reported on a monthly basis. The CPI is essentially a 'basket' that contains over 60,000 goods and services grouped by class. For more information on CPI, please visit this (LINK)

This index affects nearly all Canadians as it is the underlying number on which many pension promises are made, including the Canada Pension Plan & Old Age Security along with many defined benefit pensions. Along with this, many employers use the CPI as a gauge to determine how much to pay their staff, particularly in unionized and public-sector workplaces. Similarly, terms of rent prices on residential property are governed by limitations relating to this index, which affects real estate investors.

What's wrong with the index?

The more the index increases, the more governments have to pay their staff, pensioners and citizens seeing as these payouts are increased along with CPI. In 1983, CPI rose by 12%. The government, recognizing that it has promised pensioners and employees increases in their benefits to match CPI which was becoming increasingly more expensive, decided to change the way CPI was calculated. By including a greater variety of items, the indexes usefulness as a number on which to base cost-of-living became diluted. This began the decoupling between the CPI and a useful cost-of-living index.

In 1995, the index calculation was changed once again and according to some estimates, this reconfiguration saved the US government over $680 billion dollars over a ten year period.[1] Obviously, such cuts in benefits have real-world impacts.

Like a smokescreen blinding our vision, this leads to an inaccurate picture of the economic reality. An important factor in determining the growing wealth of a country is to compare the middle-class wage growth to CPI to determine whether or not citizens' income are growing faster than the price of the goods they buy. This produces an artificially rosy picture of the growing wealth of a nation, when in reality, more and more people are having trouble making ends meet.

The core issue here is the misuse of the CPI index as a reflection of the cost of living or inflation. At its essence, CPI is not a cost-of living index but rather an aggregate of all price movements on a large variety of goods (60,000+) rather than those required to maintain a certain standard of living. This is a fundamental problem as it is being used as an index on which to gage increases in the cost of living, both in the media and in practical terms such as pension guarantees, salary negotiations and retirement planning.

How does this affect 'regular' Canadians?

If the increase in wages, benefits and pensions are tied to an unrelated index like CPI, they are not keeping up with the 'real' cost of living increases. Over time, one's ability to maintain their desired standard of living drops as income grows at a slower pace than the rising cost of the goods they want to consume (bread, fruits, vegetables, meat, gas, etc.).

For example, if your income grows by 2% per year, but it costs you 5% more per year to sustain yourself, then within five years, you have to learn to live with ten percent less goods, 9 years – 20% less, 16 years – 35% less, 25 years – 50% less. They are not exactly looking like the 'Golden Years' when you are forced to consume 50% less goods, despite the illusion of a growing income.

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Clearly, this affects all Canadians, from students entering the work force earning low-income jobs in an unattainable real estate market to retirees living on fixed pension incomes. Over time, this weakens the middle-class whose income is more likely to be tied to CPI.

The long-term effect of this policy on the middle-class can be further evidenced by the fact that despite many households having two income earners in the home, 'making ends meet' is increasingly difficult. In particular, I believe the most devastating effects of using CPI as a cost-of-living index relates to retirement planning as the assumed future needs for income and whether or not you have enough to 'make it' to retirement is based on CPI numbers.

Understanding 'Real' Returns

Why do people set aside money for investing? To grow the money and be able to buy more goods later! In essence, when you forego spending in favour of investing your hard earned dollars, you are essentially delaying your purchase in hopes that your money will grow, thus allowing you to buy more goods. If during that delay, the price of goods increases by 5%, then you need to earn more than 5% on your investment to have increased your ability to buy additional goods. In other words, you need a return on your investment that is greater than the increase in the cost of goods you will be consuming in the future to earn a 'real' return on your investment. (Return – Inflation = Real Return)

As the idea of retirement saving is to set aside money to sustain yourself in retirement, you need to forecast the amount of money you will require to live in retirement. An important facet of building an effective plan is take existing spending habits and to accurately predict the cost of maintaining this same quality of life when the price of the goods you are consuming increase over time.

Given the fact that most people's retirement plans are either based on pensions that are based on CPI, or retirement savings plans that use CPI to predict the future costs of living, I contend that many Canadians are in for a rude awakening during their 'golden years' when their dollars buy them less and less goods.

How does this affect you?

'The first step in avoiding a trap is knowing of its existence.'
-Thufir Hawat from Frank Herbert's *Dune*

Once you are aware of this potential pitfall in your long-term retirement plan, it is important to revise the figures to better reflect the impact of a higher rate of inflation. Many websites including Chapwood Index and ShadowStats produce alternative cost of living figures to help you get a better understanding of the rise in the cost of living.

By ensuring that your retirement plan addresses the possibility for a more aggressive rise in annual income requirements over time, you can help mitigate the risk of penny-pinching in retirement. Further, as is often the case with retirement planning, you can strive for a greater rate of return on your investment, or set aside more money.

For those of you who have already completed a thorough retirement plan with us, rest assured that we use our own figures for forecasting your future cost of living to ensure you don't fall victim to this trap. I encourage all clients, regardless of their age to discuss a personalized plan with us at your earliest convenience, as we are happy to help!

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