

Measuring Real Consumption and CPI Bias under Lockdown Conditions

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The Challenge

- 1. Millions of good and services become unavailable under lockdowns.**
- 2. Unprecedented situation – methods haven't been developed for this situation. Advice defaults to standard treatment of non-available products.**
- 3. Consumer expenditure patterns have clearly changed dramatically yet statistical agency practice is to use expenditure weights from a previous period; these weights are likely to be irrelevant during lockdown conditions.**
- 4. This situation risks the public and policy makers losing confidence in key economic statistics.**

International Advice to National Statistical Offices

Advice from Eurostat to European Union countries on how to calculate the EU's Harmonized Index of Consumer Prices (HICP):

The compilation of the HICP in the context of the COVID-19 crisis is guided by the following three principles:

- **Stability of the HICP weights,**
- **Compilation of indices covering the full structure of the European version of the Classification of Individual Consumption According to Purpose (ECOICOP),**
- **Minimizing the number of imputed prices and sub-indices.”**

The weights reflect “household consumption expenditure patterns of the previous year.

Advice is effectively to carry on with the standard methodology.

International Advice to National Statistical Offices

UNECE advice is similar, but notes:

In all cases, it is important to apply imputation methods that ensure the index reaches the correct level when again it becomes possible to collect prices and include them in the index.

Hence, it provides an explicit explanation for the carry on as usual methodology; i.e., when things return to “normal”, the post lockdown CPI indexes will be comparable to the pre-lockdown CPI index.

IMF advice is consistent with Eurostat and UNECE, but it is more explicit in one respect in that it rules out simple carry forward pricing and endorses inflation adjusted carry forward prices.

Empirical Evidence of Changing Expenditure: From Credit Cards in Spain

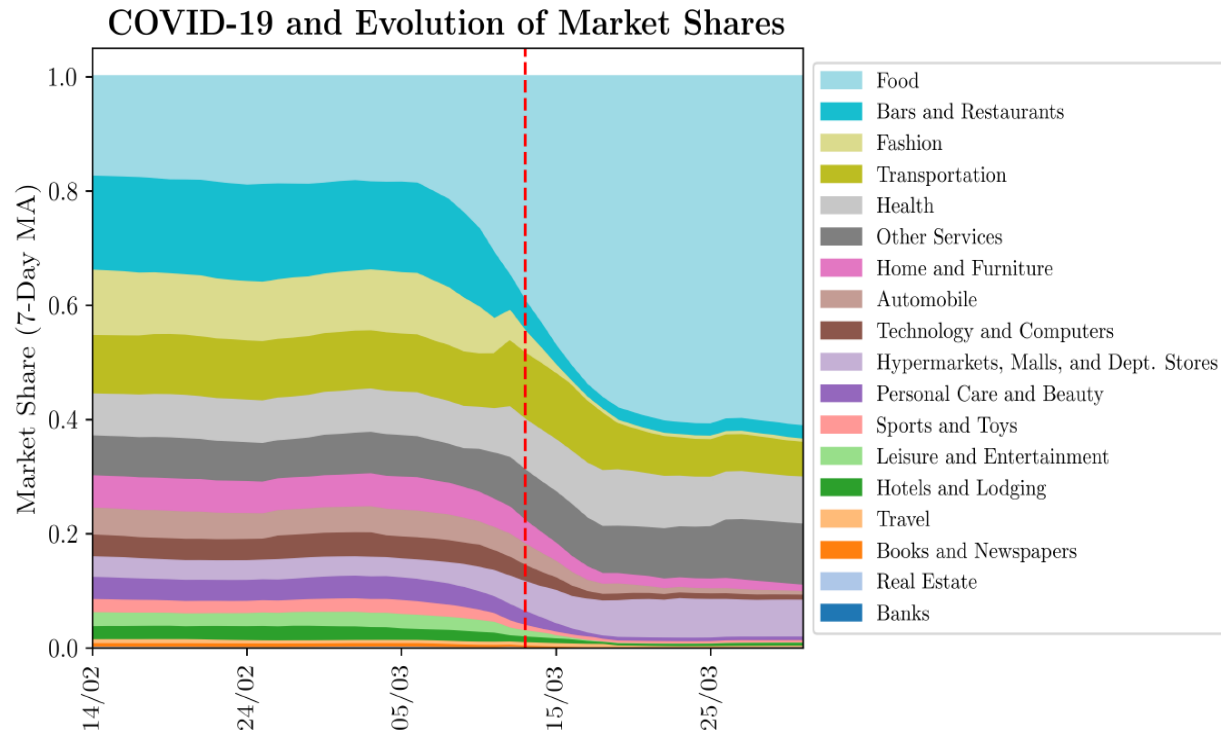
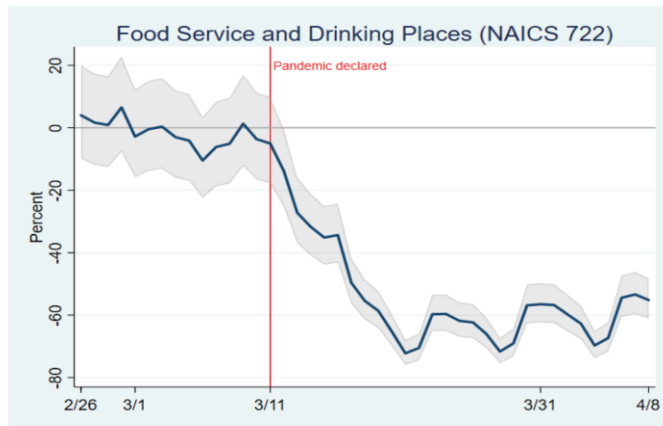


Fig. 7: The evolution of market shares for broad expenditure categories. Categories are stacked top to bottom in order of pre-crisis shares. The red dash indicates the announcement of the lockdown. Shares are expressed as a seven-day moving average.

Carvalho, V.M., J.R. Garcia, S. Hansen, Á. Ortiz, T. Rodrigo, J.V. Rodríguez Mora and J. Ruiz (2020), "Tracking the COVID-19 Crisis with High-Resolution Transaction Data", Cambridge-INET Working Paper Series No: 2020/16, University of Cambridge.

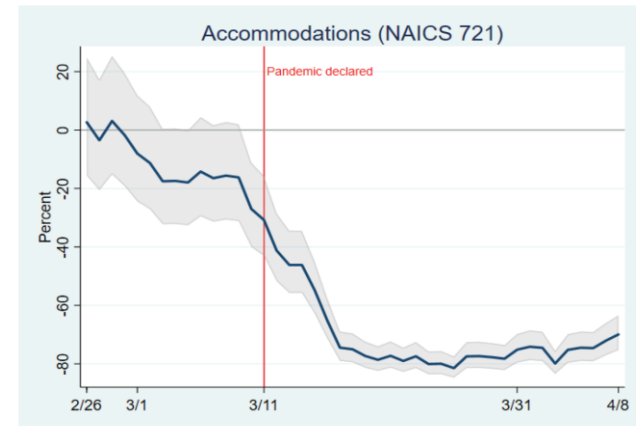
Empirical Evidence of Changing Expenditure: US

Figure 3. Event Study for Restaurants



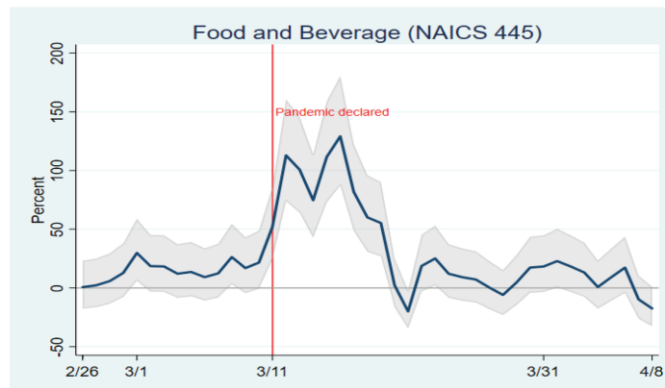
Notes. The estimates shown here have been transformed from log scale to percentages by using the exponential of the point estimate minus one, multiplied by 100. The vertical red line represents March 11, the date on which WHO declared a global pandemic. Deviations away from 0 indicate the change in the sector associated with the timing of the event. The bars represent the 95 percent confidence interval bands around the point estimate.

Figure 4. Event Study for Accommodations



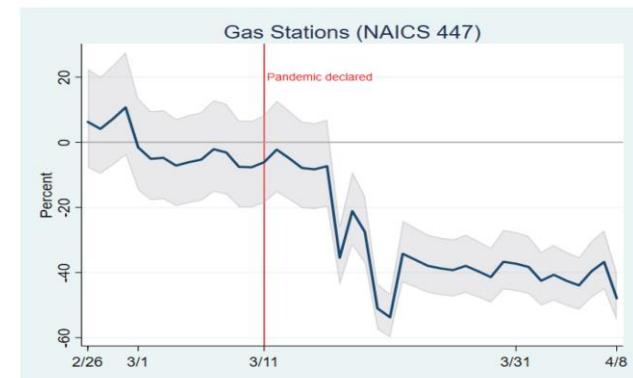
Notes. The estimates shown here have been transformed from log scale to percentages by using the exponential of the point estimate minus one, multiplied by 100. The vertical red line represents March 11, the date on which WHO declared a global pandemic. Deviations away from 0 indicate the change in the sector associated with the timing of the event. The bars represent the 95 percent confidence interval bands around the point estimate.

Figure 5. Event Study for Food and Beverage



Notes. The estimates shown here have been transformed from log scale to percentages by using the exponential of the point estimate minus one, multiplied by 100. The vertical red line represents March 11, the date on which WHO declared a global pandemic. Deviations away from 0 indicate the change in the sector associated with the timing of the event. The bars represent the 95 percent confidence interval bands around the point estimate.

Figure 6. Event Study for Gas Stations



Notes. The estimates shown here have been transformed from log scale to percentages by using the exponential of the point estimate minus one, multiplied by 100. The vertical red line represents March 11, the date on which WHO declared a global pandemic. Deviations away from 0 indicate the change in the sector associated with the timing of the event. The bars represent the 95 percent confidence interval bands around the point estimate.

Dunn, A., K. Hood and A. Driessen (2020), "Measuring the Effects of the COVID-19 Pandemic on Consumer Spending using Card Transaction Data," U.S. Bureau of Economic Analysis Working Paper WP2020-5.

Our Conclusions

1. In the short run, collect whatever prices are available and supplement these from scanner data and web scraped prices. For prices which are still missing, **use inflation adjusted carry forward prices**, consistent with current advice from the international agencies.
2. At the same time, put in motion some method for getting current expenditure weights for the consumption basket. This would require either a **continuous consumer expenditure survey** or the use of new sources of data (e.g. credit card companies, “Homescan” data).
3. Once the new consumer expenditure information becomes available, produce a **new analytic CPI**. This would be **revisable** while the new methodology was developed further. This would supplement the existing CPI.

Issues Addressed

- 1. Measurement of real consumption.**
- 2. Measurement of the CPI.**
- 3. Advantages and disadvantages of using various “practical” approaches that NSOs are likely to implement, taking into account different levels of data constraints.**
- 4. Construction of elementary indexes with a lack of matching product prices.**
- 5. Other practical measurement problems facing NSOs in CPI construction under pandemic conditions.**

Key Findings

- 1. Using carry-forward prices (either unadjusted or adjusted for inflation) will lead to:**
 - An overestimation of real consumption growth.**
 - An underestimation of changes in consumer inflation.**
- 2. Fixed basket indexes, such as the Lowe index used in most countries to construct the CPI, are inadequate when there are dramatic changes in consumer expenditure.**
- 3. Need new expenditure weights for the lockdown period. Once the lockdown ends, price change comparisons should be made with the pre-lockdown period using pre-lockdown weights.**
- 4. A revisable CPI is needed.**

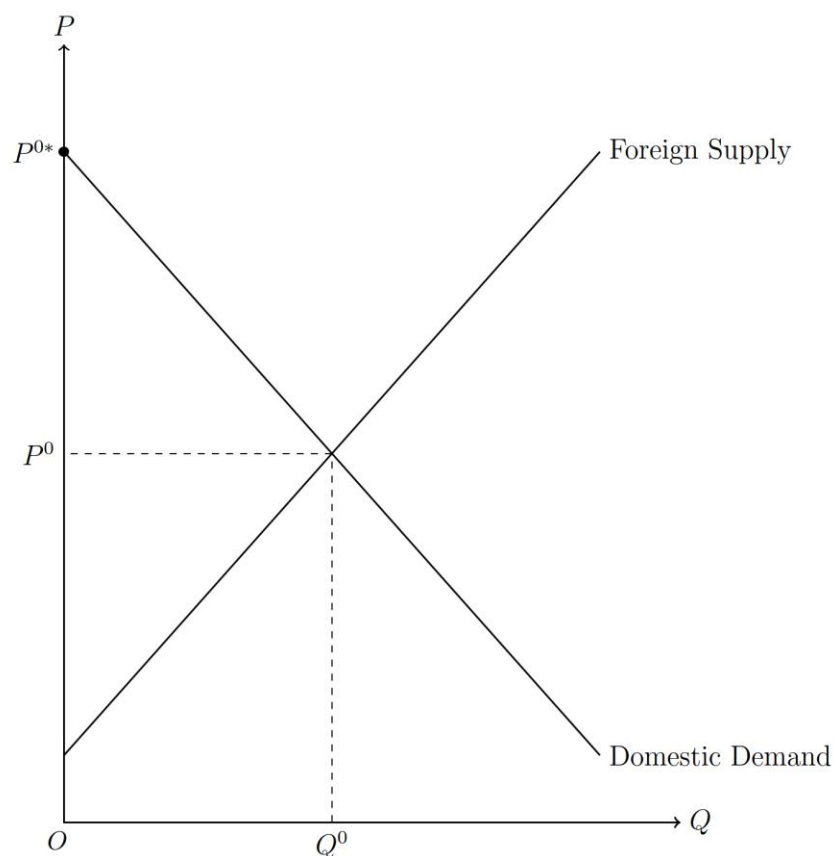
Real Consumption and CPI Biases

How to think about missing prices?

- **Quantities can be zero, but does that mean that prices are as well?**
- **Or should missing prices be modelled as being those of the previous period? (Carry forward prices)**
- **Or those of the previous period but adjusted by some modelling decision, such as an adjustment for the price inflation of other goods? (Inflation adjusted carry forward prices)**

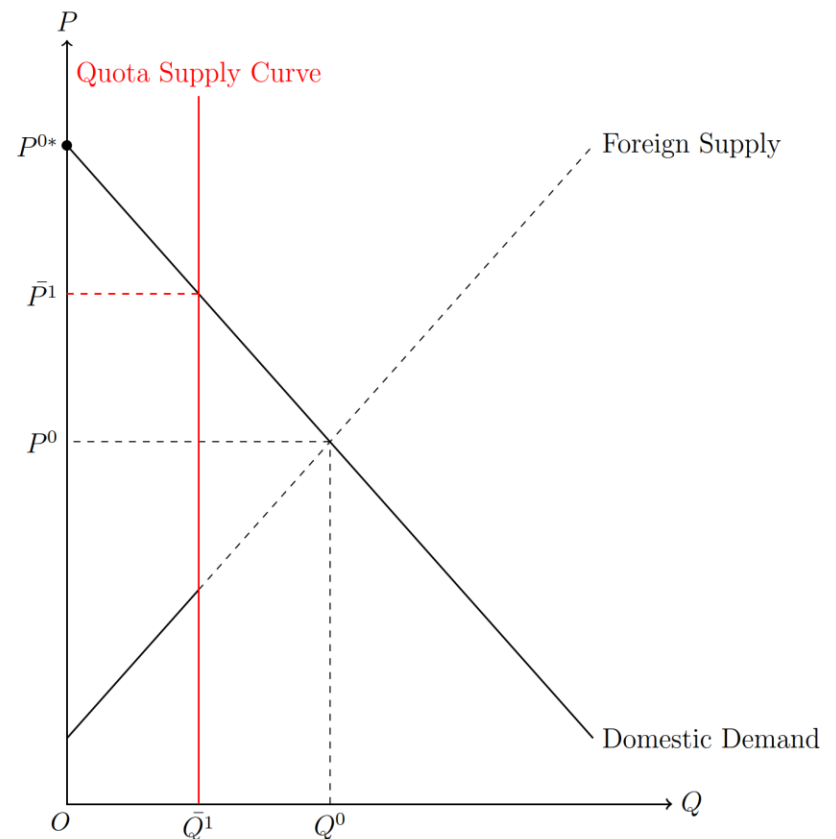
Real Consumption and CPI Biases

- Consider a simple example of an import quota on a good that is only imported. (Large country case.)
- Here's a simple supply and demand diagram for before the quota.
- Q^0 is traded at price P^0 .
- Notice the price P^{0*} , the price at which demand goes to zero.



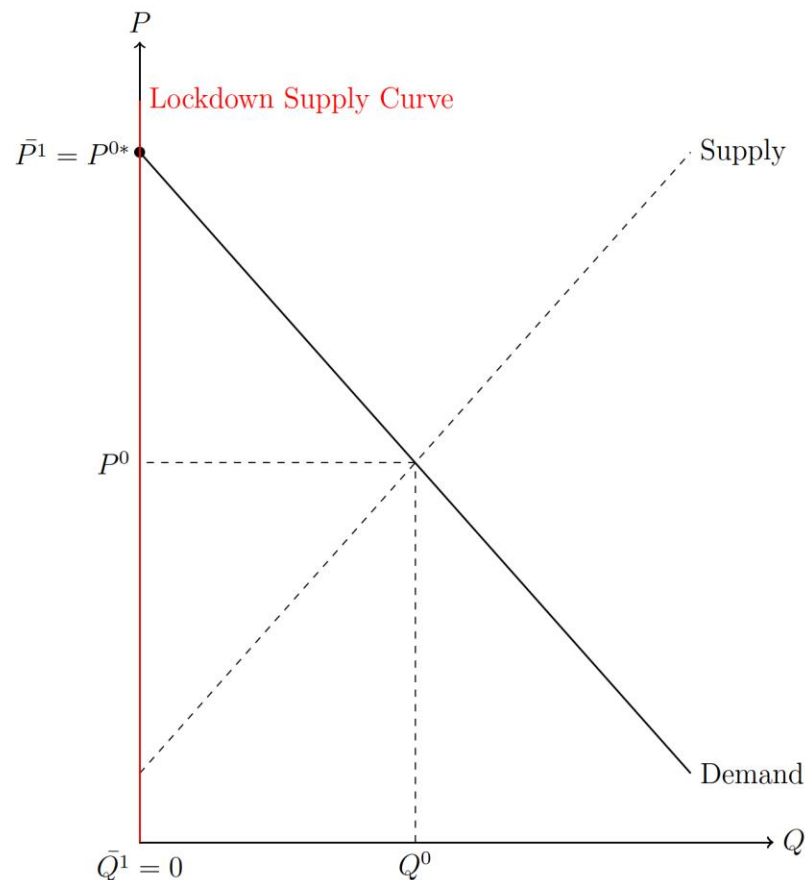
Real Consumption and CPI Biases

- Now a quota is introduced, changing the supply curve.
- Less is traded at a higher price.
- There is a loss of welfare (consumer surplus goes down).



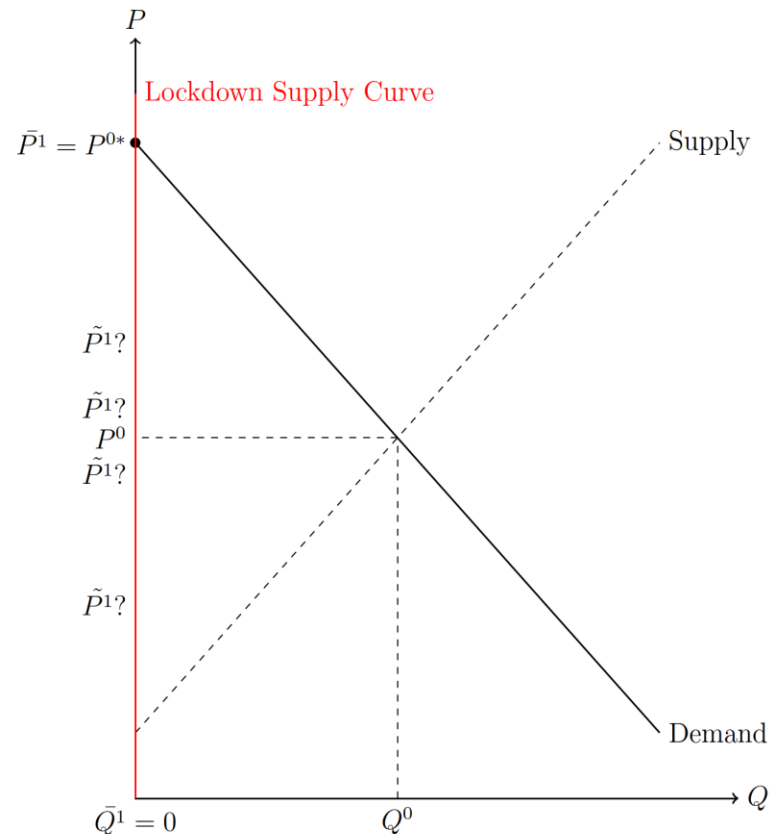
Real Consumption and CPI Biases

- Under a lockdown, the “quota” for a good is set equal to zero.
- The demand and supply curves intersect on the y-axis, at the price for which demand is zero, P^{0*} , which is the **reservation price**.
- There is a loss of welfare (consumer surplus is zero).



Real Consumption and CPI Biases

- Could choose some model to estimate period 1 price so that it's not equal to the reservation price.
- Such prices are likely to be less than the reservation price.
- For example, an inflation adjusted carry forward price.
- Problem is how to think about such prices and how to choose between them.



Real Consumption and CPI Biases

From the economic approach to index number theory, a price index is a ratio of expenditure functions with changing prices but fixed utility.

That is, consumers must have preferences over the same set of products in both periods being compared.

In the context of new goods, Hicks (1940) proposed **reservation prices: the prices that drove demand to zero** in the period before they are observed.

We adapt this to the disappearing goods context. This approach allows us to identify biases from the carry-forward prices approach.

Real Consumption and CPI Biases

A lockdown is like being sent to jail – deprived of products and confined to a particular place.

People are prepared to pay a lot of money to avoid jail, indicating that lockdowns decrease welfare.

To capture such declines in welfare, need the prices for unavailable products to be much greater than the corresponding prices in the previous period.

Reservation prices are the market clearing prices.

Real Consumption and CPI Biases

1. A theoretical (Allen) quantity index is the ratio of two expenditure functions with prices held constant and utility allowed to change. Hence, it is a measure of welfare change.
2. As (in ratio terms) we want value change = price change x quantity change, then for a fall in welfare (i.e. the quantity index) we need an increase the corresponding price index (as $Q = V/P$).
3. Inflation adjusted carry forward prices will not give this increase.
4. Hence, need reservation prices for the lockdown period, which will be much higher than carry forward prices.

Digression: Do Reservation Prices Matter for an Inflation Targeting Central Bank?

Argument: A Cost of Goods Index (COGI) is appropriate. Don't need to target a Cost of Living Index (COLI) which is based on economic theory and leads to a case for reservation prices.

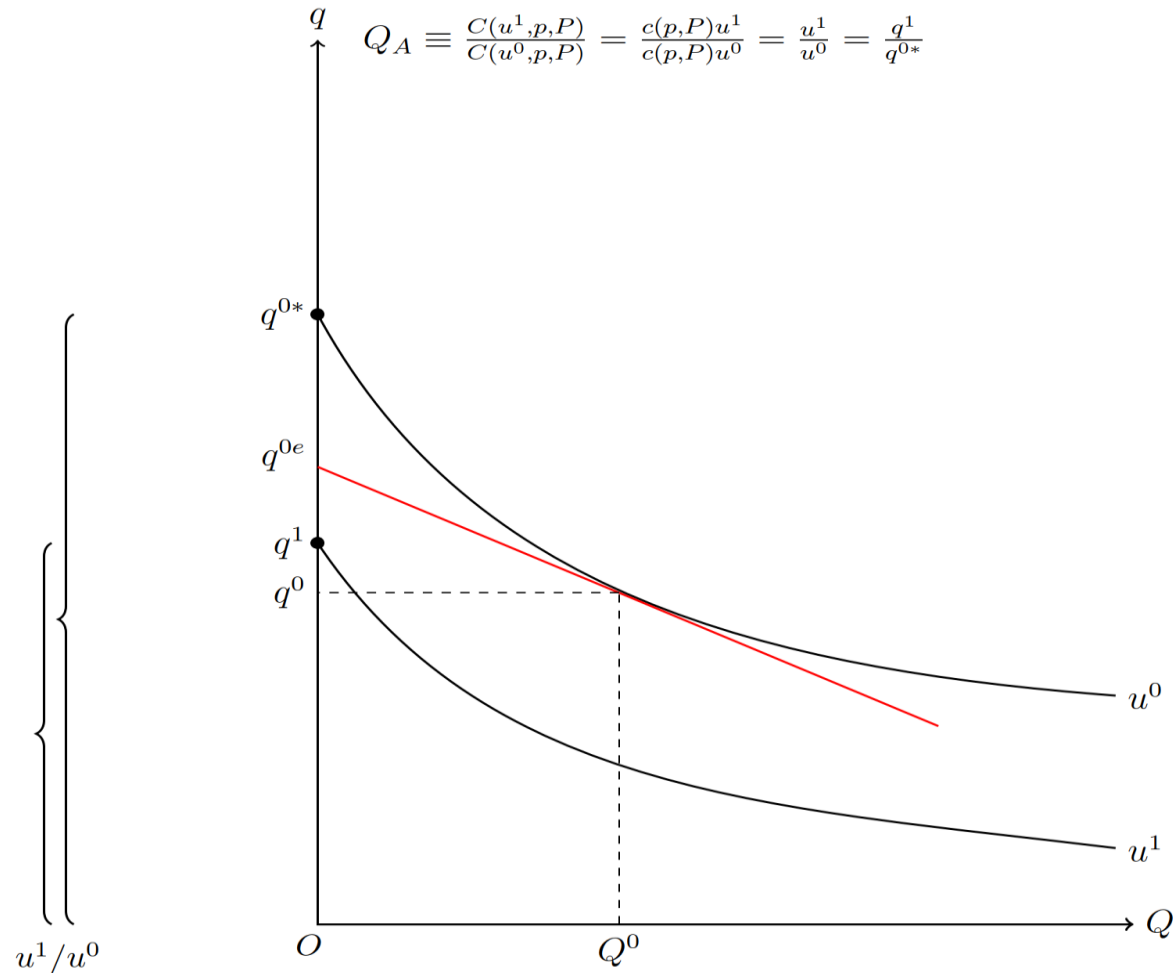
Response:

- If there's any **quality adjustment used in constructing the price index** (implicitly or explicitly), then after using the price index to deflate a value change, the quality change is reflected in the quantity index. That is, **the quantity index is capturing welfare change from quality change.**
- As the CPI in every country incorporates some kind of quality adjustment, we already have a framework where the price index is measuring changes in the cost of living (constant utility price index).

Digression: Do Reservation Prices Matter for an Inflation Targeting Central Bank?

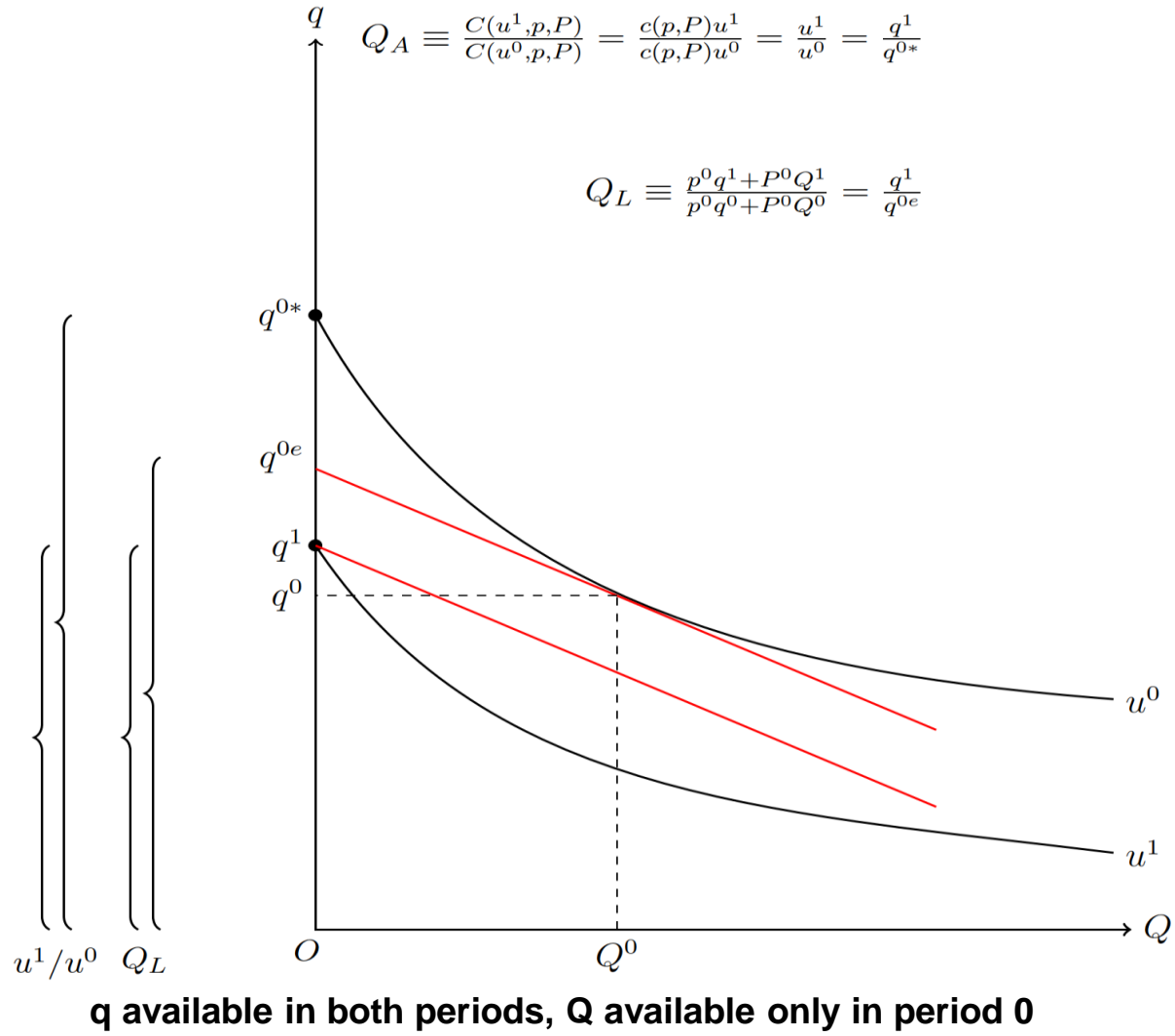
- **Normally we assume that the COGI is a reasonably good approximation to the COLI, but that's unlikely to be true at the moment.**
- **This reservation price is exactly capturing the demand-supply pressures that central banks are interested in; any lower price than the reservation price means that the market is not clearing.**

Theoretical Allen Quantity Index

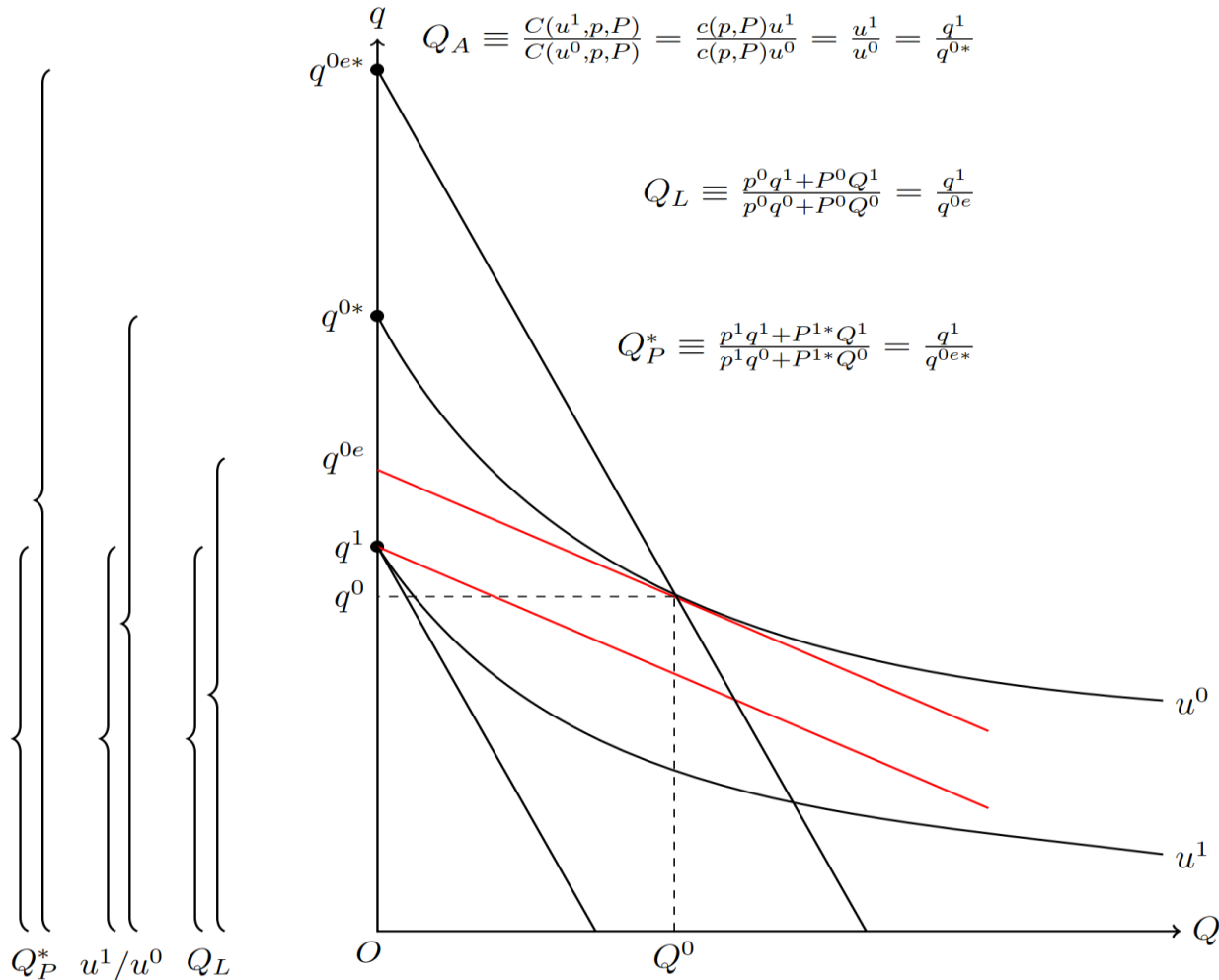


q available in both periods, Q available only in period 0

Laspeyres Quantity Index



Paasche Quantity Index



q available in both periods, Q available only in period 0

Real Consumption and CPI Biases

1. The theoretical true quantity index is bounded from below by the empirical Paasche quantity index and from above by the empirical Laspeyres quantity index.
2. Note that reservation prices only appear in the Paasche index.
3. If the reservation prices are replaced by inflation adjusted carry forward prices, then in this two-good example the Paasche and Laspeyres indexes are identical.
4. Hence, the true Allen real consumption growth will be overstated by both Laspeyres and Paasche indexes using carry forward prices.
5. Geometric mean of these is the Fisher index which will be equal to the Laspeyres index – it won't get us closer to the true Allen index.

Real Consumption and CPI Biases

6. Real consumption is usually calculated as value change deflated by a Laspeyres price index. Hence it is a Paasche quantity index.
7. The target index for an NSO in calculating real consumption is then the Paasche quantity index, not the true Allen index.
8. The true Paasche index under lockdown conditions is the one calculated with reservation prices. The Paasche index calculated with inflation adjusted carry forward prices will overestimate this.

See the paper for the general multi-good case.

Some Other Practical Problems Considered

No NSO employee price collection:

- Use web scraping and other non-traditional methods, but need to make sure that only collect prices for products that were actually consumed by any household.

Stockpiling Problem:

- Look at what to do about goods that enter and exit the consumption basket as supply-chain issues/lockdown rules change.
- CPI is constructed (mainly) on an acquisitions approach rather than a consumption approach – should it be changed to reflect consumption not taking place in the period of acquisition?

Some Other Practical Problems Considered

Free Dwelling Rent:

- If there is a policy of rent forgiveness, then these nonpaying tenants are getting free rent.
- Propose a methodology for getting reservation prices (Appendix C).
- It will typically be difficult to estimate these reservation prices, but either carry forward prices or inflation adjusted carry forward prices can be taken as approximate reservation prices.
- In this case, show how changes in price indexes will be dependent on depreciation of properties (i.e. declines in quality).

Conclusions

Our research suggests the following way forward for NSOs:

- **Collect whatever prices are available, including from non-traditional sources. For missing prices, use inflation adjusted carry forward prices.**
 - ❑ We prefer reservation prices, but acknowledge that NSOs will be unable to calculate these in a timely fashion.
- **Urgently start a program to obtain current expenditure weights for the consumption basket.**
- **Produce a revisable CPI as an analytical series that can be updated as new methodology is developed and new data sources are exploited.**
- **Explain to the public and policy makers that the usual measures of real consumption and inflation are compromised due to the pandemic...and seek a big increase in budget to address this!**