



The Quality Adjustment Shuffle

It is positively unamazing how many people ask this simple question:

**How can we be having so much disinflation
When the price of everything is rising all the time?**

There are many partial answers – many truths that each contribute to the answer – and this note deals with one of those, one that has been ignored. We call it the Quality Adjustment Shuffle, and it has been practiced regularly by the BLS – under the guidance of the Federal Reserve Board – for the last ten years.

It starts with a very legitimate idea, which is that when a certain product – bed mattresses for instance – comes in a range of quality versions, they will naturally sell at different prices reflecting the difference in quality. If the sales mix of mattresses were to change over time, the average selling price of a mattress would change even without any change in the price of a mattress of constant quality. The cost of living should be adjusted correspondingly. Imagine in particular that some engineering breakthrough lowered the cost of the highest quality mattresses. The public would rush to pay more for much higher quality. Then the average selling price of a mattress would rise even though the cost of a mattress of constant quality had actually diminished. All very logical, but not historically very relevant over the last decade.

There is another scenario. I will take the case of a single hypothetical maker of mattresses as an example. Formerly, XYZ Corp made only one kind of mattress that sold for \$400. The management sees import competition growing, and pricing pressure growing with it. With some reworking of their process and using better materials, they have introduced a new line priced at \$600. The BLS applies their quality adjustment math, which implies that the new mattress is 1½ times as good as the old one. The reasoning is that if people who want to sleep are indifferent between the two offerings, the more expensive one must provide correspondingly more “mattress.”

Now, bring on the import competition. Unit sales of the cheaper mattresses fall drastically. XYZ becomes increasingly dependent on sales of the quality mattress. But let’s suppose that their costs have risen, and it is necessary to raise the price from \$600 to \$800. They can not raise the price of the economy mattress, because they still hope to sell

some of them. We would naturally conclude that the cost of an XYZ mattress had risen a lot: nearly 33%. Since they sell primarily the quality line, their price on that line is close to their average price.

While you and we suppose that, the BLS does not suppose it. Their Quality Adjustment tells them that since XYZ Corp is still willing to sell mattresses for \$400, and since both lines continue to attract some customers, the price difference is purely a reflection of quality. That is to say, the quality mattress is now Twice as much “mattress” as the economy one. As long as there is any product line made by XYZ which – because of import competition – continues to sell at the old price, no price change on any of the other lines is attributed to inflation. It is all by assumption Quality Improvement.

Actually, one could go further. As sales of the economy line slump, XYZ management decides to slash the price in order to defend their sinking market share. They lower the price to \$300. Now they have the two product lines: an economy line selling for \$300 and a premium line selling for \$800. Therefore – in BLS reasoning – the premium mattress is now equal to $2\frac{2}{3}$ as much mattress [i.e. $\$800 / \300]. The quality adjusted selling price has actually **fallen** from \$400 per mattress to \$300 per mattress of constant quality!

So, what does this say about real product and productivity? By now everyone is aware that Gross Domestic Product adds up the dollar value of good and services produced in America and divides by the price index. For this purpose, imports don't count, because they are obviously not part of our domestic product. In the case of XYZ Corp – of its contribution to GDP – we look at sales – which is primarily sales of the premium mattress at the rate of \$800 per unit – and the index of the price of their product – an index that has diminished by 25% because they have had to meet the import competition on their economy product – has fallen. When we divide output in dollars by the resulting price index, the message is that output has expanded dramatically, along with productivity.

So to sum up: as a result of rising costs at XYZ Corp, the national income accounts have credited them with falling costs and expanding output and efficiency.

If this scenario begins to look familiar, if you think this is what has happened in industry after American industry over the last nine years, welcome to the club.

This fable, this fictional history of XYZ Corp, does not stop at this point. XYZ Corp is making fewer mattresses. Total sales nationally of mattresses may have grown, because of imports, but in any case XYZ is making less. They make fewer economy mattresses because of the competition, and their unit output of the premium mattresses has not replaced that loss because the high price limits their market. Since, therefore, they are making fewer mattresses, they can close old factories and furlough older employees. So this is how it shapes up: more “real” output, divided by fewer employees. This “equals” even larger gains in labor productivity. It takes a remarkable act of blind faith in

Alan Greenspan to believe that American workers are being laid off because they have become so much more productive than they were before.

If rising productivity causes employers to dismiss their employees – that is to say if high productivity causes unemployment – why don't the employees simply lay down on the job and take a nap rather than work? Then presumably their employers would be willing to hire more of them.

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