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VOLUME 8
ISSUE 4
FEBRUARY 21, 2006

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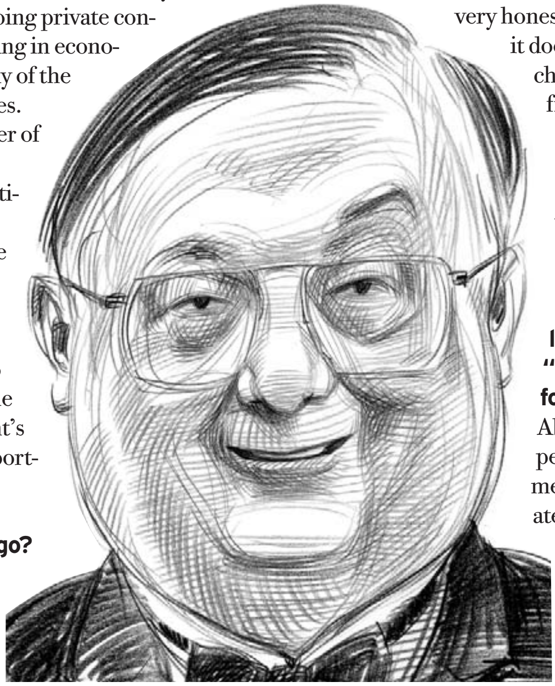
Shadowing Reality

Economist Keeps Tabs On Government's "Creative" Statistical Reports

Walter J. (John) Williams is the **John Williams** *behind a fascinating website,* **www.shadowstats.com***, which promises—and delivers—"analysis behind and beyond government economic reporting." An old hand at peeling away layers of spin and mathematical machinations to reveal kernels of economic reality, the consultant launched his website in late 2004. A series of essays he had penned on the government's statistical shenanigans for friend* **Doug Gillespie***'s* **GillespieResearch.com** *stirred so much response, John says, he basically had no choice but to start his electronic letter to efficiently distribute his scrubbed statistics and economic views. He shares both in this interview.*
KMW

You have been a practicing economist for a long time, as I understand it—and one of these days you hope to get a forecast right. Isn't that the line?
Right! I've been a practicing economist with my own business for about 25 years, doing private consulting. I started out specializing in econometric forecasting, particularly of the U.S. economy and interest rates. Early clients included a number of large companies; Fortune 50 companies, large financial institutions. We did very well with our economic and interest rate forecasting but early on I noticed that something seemed to be askew with the GNP forecast. As I looked into it, I found that there were some problems with the government's GNP reports, tied to to misreporting of the trade deficit and–



This was about 25 years ago?
Oh, yes, this is back in the early '80s. Anyway, when we corrected the trade numbers in the GNP reports, our GNP forecasts started working well again. This was very important to us because we had a large client, a company that sold commercial airplanes and used to model revenue passenger miles to forecast their business demand–and their model was dependent on the GNP statistics. It had stopped working but when we plugged in our *revised* GNP numbers, all of a sudden things seemed to fit. At that point I realized that I really had to become fully familiar with how all of the government's economic statistics are put together.

A truly dismal prospect.
A very dismal prospect. No question, this is the dismal end of the science– even for a dismal scientist! But the longer I've looked at the numbers and the statistical series as they've evolved over the decades, the more that I've started finding things in the numbers that most people do not see. One thing that you find when you look into all this is that the federal government is very honest in terms of disclosing what it does. It always footnotes the changes and provides all the fine details. Nonetheless, some of the changes are nothing short of remarkable and the pattern over time is what I call Pollyanna Creep–

So you're saying that if government decides to label an elephant a "mouse," it fesses up in a footnote. How sporting.
Absolutely. What has happened over time is that the methodologies employed to create the widely followed series, such as what used to be called the GNP but is now widely followed as the GDP, the CPI, the employment numbers, all have had bias-

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Published exclusively for clients of Weeden & Co. LP

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welling@weeden, an exclusive service for clients and prospective clients of Weeden & Co. LP, is published biweekly on Friday mornings, by welling@weeden, a research division of Weeden & Co. LP. Editorial and partnership offices are located at 145 Mason Street Greenwich, CT 06830. Telephone: (203) 861-9814 Fax: (203) 618-1752 Email: welling@weedenco.com jean_galvin@weedenco.com. First-class postage is paid at Stamford, CT

Victor Juhasz
Page 1 Illustration

es built into them that result in overstating economic growth and understating inflation– both of which are admirable political goals–

But?

These overstatements have become such a serious problem that there is a little bit of a disconnect today between what a person on Main Street thinks is happening and the economic numbers you see coming out of the federal government. If you go back, I'm guessing it was five to ten years ago, the **Kaiser Foundation** conducted a survey of the public's views on the levels of the CPI, unemployment, GDP growth and such, which was reported in the *Washington Post.* The gist of all the article was, "Ho, ho, ho, ho. Look how stupid the American people are. They don't realize that inflation is so low and that unemployment is so low." But the joke was really on the guys doing the survey, because the average person has a pretty good sense of where prices and things are. If the numbers don't seem real to the man in the street, they probably aren't. Real unemployment right now–figured the way that the average person thinks of unemployment, meaning figured the way it was estimated back during the Great Depression–is running about 12%. Real CPI right now is running at about 8%. And the real GDP probably is in contraction. I venture that if you talked about those numbers now with the average person, they would say that they seem reasonable. If you tell them that people are playing with the official numbers, they say, "Yep, I figured that. There are no great surprises there." I guess what I am saying is that my work shows that the economic perceptions of non-professionals actually have some real validity; there are in fact reasons for the disconnect between official statistics and what the populous is feeling.

"If the numbers don't seem real to the man in the street, they probably aren't."

All of these changes you're talking about in the statistics have occurred very slowly, in just tiny incremental steps, over the years?

Yes. I'm talking from firsthand experience going back to the early '80s, although I have had a number of clients and associates, some of whom went back to the days of Herbert Hoover. Back in the pre-Great Depression days, there really were almost no modern economic statistics. There was a crude industrial production number. Elements of the Consumer Price Index actually have roots that go back to 1888, when an index was created to measure the effects of a tariff act, and it was used in World War I to help in set wage scales for shipbuilders. But it was not widely used or followed until after World War II. In fact, before the Great Depression, most people looked at the stock market for an indication of how the economy was doing. If stocks were up, the economy was strong; if stocks were down, you had trouble. So when Herbert Hoover was faced with the Great Depression, he really had no way of measuring how bad it was.

He might have checked a few bread lines. Or Hooverville's.

Oh, people knew it was bad. They just didn't know quite *how bad* it was. The kind of detailed modern reporting that we see the National Income Accounts, for example, weren't published until after WWII. The unemployment numbers as we see them pretty much came into popular use at that time. The CPI really gained its prominence as a way to adjust autoworker contracts, and so the cities that were surveyed for the CPI were where all the automobile facilities were.

Coming back to the present, you're saying that the government's economic statistics have a persistently rosy bias?

Exactly. What happened is that it took the politicians about a decade before they figured out, "Well, we can get rid of the bad news here, or make it look a little better, and that might help us in the next election." The first incident that I'm aware of occurred during the Kennedy Administration –which was then maybe 10 years after the economic numbers came to be fairly widely used.

They needed a little help in Camelot?

What they did was redefine "unemployment." They created a category of unemployed called "discouraged workers." If you were unemployed and you'd given up looking because there was no work to be had, you were counted as a discouraged worker–but taken out of the unemployment count. They still counted you, at least, until the Bill Clinton Administration, when they said, "Well, we really need to define discouraged workers–so if anyone has been discouraged for more than a year, we're just going to take them out of all the numbers, take them out of the workforce completely". In doing so, they knocked about 5 million unemployed out of the broader measures of unemployment. Today there are seven or eight unemployment measures that are published each month. The one they call U-3 is the popularly followed one. The broadest one right now is U-6, which is running up around 9%. But, as I mentioned, if you take out all the funny games that they've played with it, unemployment is really up around 12%. After the Kennedy Administration, of course, came Lyndon Johnson's presidency. One of my clients was an economist at the Commerce Department during the Johnson years and he says that whenever Johnson got the GNP report, he would look at it–and if he didn't like it, he'd send it back. And he would keep sending it back until the Commerce Department got it right! Then we had the Nixon Administration. Mr. Nixon did not like the Labor Department. He thought–I don't want to get accused of any insensitivity here, but I am quoting the *New York Times* on this–Nixon thought there was a "Jewish cabal" at the Bureau of Labor Statistics.

"LOOK, KIDS! THEY'RE DIGGING YOUR SHARE OF THE NATIONAL DEBT!"

You don't have to quote the *Times*. Nixon recorded himself for posterity. That's in the Watergate tapes.
Yes. Anyway, there was a census taken and Mr. Nixon tried to change the reporting of the census numbers. My understanding is that his efforts were unsuccessful, but the Bush II Administration actually got some of the changes that Nixon wanted many years ago into play. In the Jimmy Carter Administration, inflation was understated. During the Reagan Administration, there were methodological changes made to the GNP–and there was an actual overt manipulation of the trade data following the stock market crash in '87. At the end of that year, as the dollar was crashing, manipulating the trade data was part of an effort to turn the dollar to the upside. There had been a series of real bad trade numbers and, they psyched out the markets by coming up with a really good trade report. It amounted to a massive intervention but they succeeded in bottoming out the dollar and successfully turned the market. It was a very dangerous time and I guess you could justify that intervention on the basis of national security or economic security. But then along came George Bush–

George Bush I or II?
George Bush the First. They had a circumstance where they opted for overt manipulation. Let me step back a minute. There are two types of manipulation of the data. You have the systemic manipulations, where methodologies are changed. Again, the methodologies almost always have an upward bias in growth and a downward bias in inflation–and that's not coincidental.

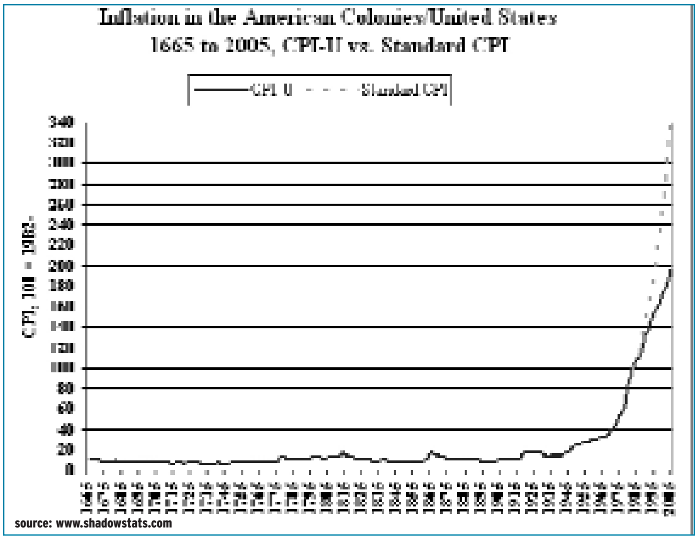
That's almost a natural law, isn't it?
Yes, very much so. The other type of manipulation is when someone does something to the numbers to make them come out a certain way at a certain time. Mr. Bush had a real tough reelection campaign. He had a recession weighing against him.

And an opponent clever enough to grasp that "It's the economy, stupid," would resonate with the voters.
Right. What happened is that a senior Commerce Department official went to an old friend, a high-level executive in the computer industry, and said, "Gee, we've got to get the President re-elected. We want you to boost your sales reports to the Bureau of Economic Analysis." That happened. It spiked the GDP numbers. I knew people involved in getting it done, ones on the outside of the Bureau of Economic Analysis. And I've confirmed separately with people inside the Bureau of Economic Analysis that it happened.

Well, that was one overt manipulation that didn't work.
Absolutely. Because, again, the man in the street has a pretty good idea about how things are going. When the President gives a campaign speech and says, "Hey, the economy's booming," but the guy on the street is thinking, "You're nuts, I'm out of work," people recognize the disconnect. They think, "The man is out of touch with reality." I've heard some comments like that recently, and it's not that the President is out of touch with reality, it's just that the reported statistics have generally been so strong against what is really *not* a very strong economy.

Can you give me a specific example of what you're talking about when you refer to systemic manipulations?
One of the prime examples of how the system has really degenerated over time is the CPI. There was a very deliberate effort in the early 1990s under the auspices of Michael Boskin, who at the time was the head of the Council of Economic Advisors, in conjunction with Alan Greenspan, who, of course, was Fed Chairman, to "fix" the CPI. The story, very simply, was that CPI was supposedly overstating inflation. The pitch was that if people go out to shop and find that buying a steak is getting expensive, they buy hamburger instead. Therefore, their cost of living is really less than it would be if they always had to buy a fixed basket of goods, which is what the CPI was originally designed to measure. That was the whole purpose of the CPI, to measure the change in the cost of a *fixed* basket of goods over time. You'd have a steak, a loaf of bread, a gallon of milk, whatever. You'd price them out one year and then you'd price out exactly the same goods the next year. You'd look at the difference in the cost and that was your annual rate of inflation. It was a measure of how much the cost of a consistent and constant standard of living was going up. What Boskin and Greenspan argued was, "We should allow for substitution here because people can buy hamburger instead of steak, when steak goes up." The problem is that if you allow substitutions, you aren't measuring a constant standard of living. You're measuring the cost of survival. You can keep substituting down and have people buy dog food instead of hamburger. It happens. But that's not the original concept behind the CPI. The reason substitution of the items in the CPI basket became a hot topic in Washington at the time–and it was talked about very openly–was because the CPI was (and is) being used to adjust Social Security payments to compensate for increases in the cost of living, and tamping it down would hold down Uncle Sam's outlays.

Squeezing retirees to slow the growth of the deficit–
Right. In fact, that was why there was a political furor over the proposal



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that it got killed at the time. Everything died down and the notion seemed to be forgotten. But then during the Clinton Administration, the Bureau of Labor Statistics, on its own, changed the weighting method for the CPI. It had been constructed using arithmetic weightings, which meant doing things the way most people would add and subtract and divide. The BLS changed it to a geometric weighting, which has the "benefit" that if something goes up in price, it automatically gets a lower weight, and if it goes down in price, it automatically gets a higher weight. That change was implemented over a period of several years. The rationale was that it was a way of approximating the substitution effect. But it isn't. I mean, it is just a pure mathematical game. In the second Bush Administration, they introduced what they call the chained, or C-CPI-U, as an alternate CPI measure. And this measure, the C-CPI-U, is a direct measure of the substitution effect. It is running a half a percent-to a percent below the official CPI–which itself is running, oh, about 2.7% below where it was before the weighting changes were made in the Clinton Administration. All in all, if you were to peel back changes that were made in the CPI going back to the Carter years, you'd see that the CPI would now be 3.5%-4% higher. The difference that it makes is significant: if the same CPI were used today as was used when Jimmy Carter was President, Social Security checks would be 70% higher.

Seven-zero?
70%. You have to keep in mind that all these changes were cumulative.

You haven't even mentioned hedonic adjustments.
Oh, that's all part of it, too. I mean, my goodness! Take anything that you can think of whose price is going up. The BLS says the price really isn't going up, as long as the product has been improved in the interim, because you're getting greater benefit from it. After they get finished with their hedonic adjustments, the "price" might even be down, particularly for things like computers and other electronics. My favorite example of this, even though it has gotten a little old, is just a perfect illustration of how the government works. Sometime in the 1990s, I don't remember the exact timing, federal air pollution regulations were put in place that mandated adding a certain additive to gasoline, which increased the price of gasoline by 10 cents a gallon. Now, because air quality was supposed to be improved by this additive, that 10 cents per gallon price rise was *not* counted in the CPI. That was a hedonic adjustment for the improved quality of the gasoline. The irony is that they later discovered that the additive did not work as advertised and they had to pull it out of gasoline–and I'm pretty sure the price of gasoline didn't go down by a dime a gallon when it was pulled out. Of course, that is a problem that you see in lots of areas. When gasoline prices go up at the pump because of rising oil prices, they are very slow to show up in the CPI, yet when oil prices come down, immediately you see a drop in the CPI and the downward pressure on the gauge even lingers a little bit, which was what happened in the December report. In the real world, it's just the opposite. Gas stations are generally slow to lower prices, but very quick to raise them. For instance, if you look at the retail sales report for December, you see that gasoline sales in dollars were up pretty sharply, which was largely due to higher gasoline prices–at a time when the December CPI was down. You'll see some adjustment in that in January, but those games are played month in, month out with oil prices. But I don't mean to harp on the Bush I Administration because under Bill Clinton they really mastered massaging the data. Bob Reich, in his memoirs, wrote that they found in their polling that if you could overstate economic growth, understate inflation, tell people things were better than they really were, it could help you win in a tight election. That was their conclusion. So, of course, they moved in that direction.

But you were saying earlier that the public isn't fooled—
Well, if things are bad enough, there is not much that fooling around with the numbers is going to do. But if a race is close, it can be another matter. Then too, Reich was talking about looking at it after Clinton had taken the White House and they were putting together the Clinton economic "miracle"–which really was miraculous in any number of ways.

The tone of your voice says it was anything but a miracle.
Let me give you another example. The employment statistics were another area that was very heavily played with. There was a period during the Clinton Administration when month after month, 250,000 jobs were being created, *exactly* 250,000 jobs. They'd play around with the initial reports a little bit, but after a month or two you could look at the raw numbers and you could see the monthly changes were exactly 250,000–or over two months they were exactly 500,000. The chances of the numbers coming out like that on a random basis were something like one in 10 million. That was one of the times that my questions got people in the Clinton Administration angry at me. But their manipulations got more and more brazen as they went along. Not only were the CPI numbers reset using the geometric weighting, but they also changed the polling sample for the unemployment database. They basically reduced the number of people being surveyed in the inner cities, and then claimed they had replaced them statistically. But the effect was immediate: You saw a drop in all the unemployment measures that would normally be influenced by inner-city surveying. Reported unemployment among people of color declined sharply and the piggybacked poverty survey showed a remarkable reversal in what had been a decades-long trend of worsening poverty. But it was nothing more than statistical games playing with the survey base. It wouldn't surprise you to learn that this happened within a year or so of Clinton's re-election bid, would it?

I'm shocked, shocked, I tell you.
The man was masterful. There is something about him that tickled people's fancies. I mean, he was a scoundrel and people at heart sort of like a scoundrel. I called him Tricky Slick. But at least you could have a good laugh over it and you knew when Clinton was playing games with you. I'm not so sure that we're seeing that same attitude today. Certainly, the current administration is not as popular as Bill Clinton's was. I'll tell you up front, I'm a Republican by birth, a conservative, and frankly, disgusted by both parties at this point, especially because we

have no one of substance taking on very severe issues, like the trade deficit and the federal deficit, that are going to create terrible times for people in this country if they're not addressed.

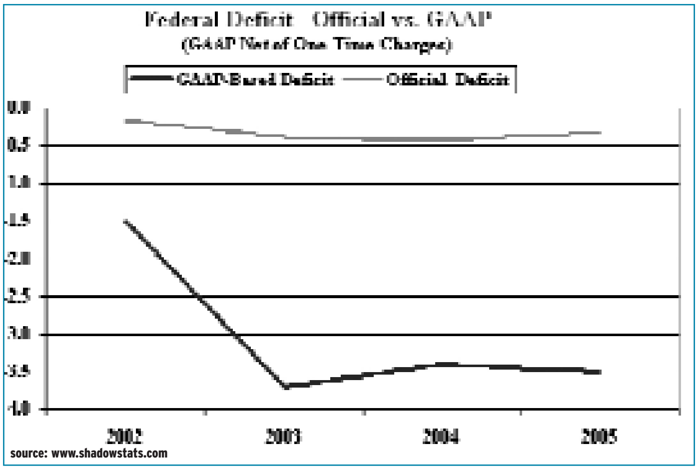
So massaging economic statistics is a bipartisan effort; after all, whoever is in power has the keys to the statistics store.
Indeed. That's why, generally, one Administration does not call the previous one on it. It is, as you're suggesting, a perk of office.

Here's the question, John. Why go to all the trouble you do to try to track all this so minutely, when you could just as well be trying to pin down Jello? Especially because, as you say, when they stray too far from reality, people do catch on?
Well, because people who run companies and people who invest do need to use these numbers. If you're trying to predict sales or profits for a company and you're using the government's numbers on GDP, you may find that it is very difficult to do. But if you make certain adjustments to the government's data, you may find that your sales trends all of a sudden are much more explainable and predictable. Meanwhile, people who take the numbers at face value and make investment or business decisions on that basis may have some unhappy surprises down the road–surprises that would be preventable if they knew how they were being misled. Most people aren't aware of the extent of the problem and most Wall Street economists will tell a happy story. They pretty much have to; nobody wants to come out and rattle the market. There are exceptions, of course, but generally there's a very strong business reason why Wall Street economists, and economists for large banks, tend to always have an upbeat view.

No kidding.
Yes. But there are many people who don't understand that. If someone gets hurt because they put the money in the stock market, based on all sorts of happy economic reports, and next year, the economy and the market fall apart, whom do they blame but themselves? That's why I've done this all these years, to be able, I hope, to give investors accurate forecasts. I'm not perfect, but I generally do reasonably well in predicting things like the direction of interest rates. Now there is something, though, that is so far out of whack and so dangerous that if it isn't addressed–and I'm afraid maybe even if it *is* addressed–that it has gone beyond hope of repair, at least in any way that the system normally handles things. And that is the fiscal condition of the federal government.

Gee, President Bush's recent comments on the budget were pretty self-congratulatory.
Well, yes, even if he hasn't been able to crow about a surplus like Bill Clinton–then again, there never really was a surplus. And even a lot of people who consider themselves well-versed probably don't realize just how awful our fiscal situation is. Let me just give you a bit of the historical background: Back in the mid-1970s, what were then the big 10 accounting firms decided in good public spirit that they would help the federal government set up its books on an accrual basis so that it could prepare financial statements and report its business the same way that a company does.

How quaintly naïve, but anyway–
Well, but they tried, and actually got a system going. Into the Reagan Administration, they were actually putting out prototype statements. But something was throwing the statements off–accruals for Social Security. It was decided during the Reagan Administration that dealing up front with those liabilities was really too political. They backed it off and Social Security got thrown into the footnotes. Even so, the accounting system continued to evolve and in 2001, the first annual



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Congressionally mandated *Financial Report of United States Government,* for 2000, was published by the Treasury. It is prepared using generally accepted accounting principles, or GAAP, except for Social Security and similar accounts, such as Medicare, Medicaid and the Railroad Retirement Fund. Every year since then, these statements have been published, and to the credit of the Bush II Administration, the recent ones have even included indications of what the Social Security numbers would look like, if they were included in the accounting, similar to the way corporations show pension and retiree benefit liabilities. These financial statements are audited by the Government Accountability Office. But the GAO won't *certify* them. They include all sorts of disclaimers and discussions of material reporting issues–things like the fact that Defense Department and Homeland Security can't track the money that they are spending. Still, those are separate issues. They at least *do* put out a financial statement. It's the best they can come up with. Treasury Secretary Snow and his predecessors have signed off on it. Keep in mind, now, that while other than in the footnotes, this financial statement doesn't include any accruals for Social Security or Medicare liabilities down the road, in general, it is an exercise in accrual accounting. It includes accounts receivable, accounts payable. If they buy a building, it is capitalized and depreciated. Weapons go into inventory. The business of government is treated just like any business. This near-GAAP financial statement stands in sharp contrast to what I call the gimmicked reporting of the government's budget which is commonly reported. The budget deficit numbers you hear announced at White House press conferences are from accounts kept on a cash basis, with no accruals made for monies owed by or due to the government in the future. Even though the surplus of FICA payments it currently receives over Social Security payments it makes are counted as a cash infusion, there is no offsetting liability for future outlays, so Social Security taxes have been artificially lowering the deficit level for years–actually, going back to the days of Lyndon Johnson. Faced with growing opposition to the war in Vietnam, he decided he had to do something to make the budget look a little better, so he got Congress to go along with changing the accounting of Social Security receipts. And that lopsided accounting has persisted ever since.

How much difference does all this make, in dollars?
Well, if you look at 2005, the official deficit was reported at around $319 billion. Using generally accepted accounting principles, the 2005 Financial Report of the U.S. Government published by the U.S. Treasury, showed a deficit of $760 billion. That's without considering Social Security and Medicare. However, in the 2004 report's management discussion and analysis section, the Bush II Administration basically said, "Hey, guys, you'd better be aware of how these numbers work." Where the official federal deficit in 2004 was reported at about $412 billion, and the GAAP-based deficit was around $616 billion, they said that if you added in the net present value of the underfunding of Social Security and Medicare, the one-year deficit in 2004 was $11.1 trillion. That's *trillion*, not billion. That amounted to almost 100% of GDP at the time. Now, that $11 trillion included a one-time spike of about $8 trillion, to account for what Congress and the President did in setting up the Medicare drug benefit without funding it going forward. But you can see that if you back out that one-time charge, that on a GAAP basis, accounting for Social Security and Medicare, in 2003 the deficit was around $3.7 trillion; in 2004 it was $3.4 trillion; and in 2005 it was $3.5 trillion. We've had three years in a row here where the GAAP deficit has been basically $3.5 trillion. So the deficit and the total obligations of the federal government are increasing by roughly the amount of GDP every three years. In fact, the fiscal 2005 statement shows that total federal obligations at the end September were $51 trillion; over four times the level of GDP. It is unprecedented for a major country to have its actual obligations so far out of whack.

That's some whopping credit card bill.
It's beyond control. Keep in mind that 2005's $3.5 trillion GAAP deficit is roughly 10 times bigger than the "official" deficit. But that is the size of the shortfall. Even if you were to raise personal income taxes to 100%, take all of everyone's salaries, and put all those funds into a pot against this deficit, you'd still have a deficit. (If you also threw in corporate taxes, you actually might get it a little bit to the plus side.) But we are at a point where we cannot cover the deficit by raising taxes. So what are we doing? We are *lowering* taxes to try to stimulate the economy. People are talking about new big *spending* programs going forward. Yet you'd have to cut back Social Security and Medicare drastically here, beyond anything that I can imagine is politically feasible, to bring things into balance. Of course, there is no way you can tax all of people's income. And I think it's a political impossibility to eliminate Social Security and Medicare, or a goodly portion of it. But that is the political situation we're faced with right now. This is why I really refuse to align myself with any of these jokers down in Washington (to use as sensitive, or as gentle a term as I can for them). Those people have a thinking horizon, a planning horizon, of the next election.

Is there any other?
It's not that people in Washington don't know what is going on. My goodness, John Snow signed off on the statement! In 2004, he said, "Hey, we had better be aware this is a real problem." But in the 2005 report they buried it again. It's there. You can tease it out of the numbers, but there has been a big shift in the political agenda. Even Alan Greenspan, before he left office, was talking some about how the Congress and the President should tell the American people that there is no way that the government can pay them the Social Security or Medicare that it has committed to.

Why not just continue robbing Peter to pay Paul?
You have to consider that in the last, oh, decade or two as our federal debt has expanded, a lot of our Treasuries have been absorbed by foreign investors. A lot of our debt has been absorbed in recent years by central banks that have been sitting with substantial dollars they've picked up because of our explosive trade deficit. Last year alone foreign investors bought enough federal debt to cover all the debt issuance that the Treasury did.

You're saying we're dependent on the kindness of strangers. But as long as they're willing—and benefiting by being able to sell us stuff—
Yes, everything is fine as long as we have adequate liquidity in the equities markets and the credit markets, but if something changes– I mean, my goodness, suppose there's a little bit of a political shift among the Asian nations or that one of the OPEC members–I mean, just today Syria has announced they are moving to using euros instead of dollars for all foreign exchange transactions and I know that Iran has made noises about pricing oil in euros. It does not take much to start a run. I can't tell you how it will start or who will start it. China has been making noises about not getting as heavily into dollars. Of course, the U.S. puts political pressure on all the big holders of dollars to keep doing exactly what they have been doing, but they all know it's a losing proposition. At some point, the Fed is going to have to start monetizing the debt because there are not going to be enough people to buy it. Either that, or we are going to see a terrible spike in interest rates. The process will eventually lead to a very high rate of inflation, high interest rates and a very sharp decline in the dollar. If you are a central bank holding $800 billion in foreign currency reserves, that's a lot of money. You don't really want to take as big a hit on it as you might–

Which is the reason nobody's going to make the first move, or so the argument goes.
Those are famous last words. The point is that you are dealing with people where someone is going to lose money. Everyone knows it. The question is, who is going to be left with losses and who is going to be the first to get out the door? I can't tell you how it's going to break, but it's the type of thing that could break any time. I mean, it could be three years off or it could be next week. But once the selling pressure starts, it's going to be massive. You're going to see a lot of dumping of U.S. securities, particularly Treasuries. To absorb them, you're going to see a sharp spike in rates or the Fed will step in and provide liquidity to the market and buy them. My betting is, especially with Mr. Bernanke, who is a student of what happened in the Great Depression, now in charge, that he has some ideas about what is going to happen here. If you look at what happened in the banking collapse in the early '30s, it's widely believed now that the Fed made a mistake in not pumping liquidity into the system. They let the money supply collapse as the banking system collapsed and that tended to accelerate the deflation and the depression; made the depression deeper than it perhaps had to be. So going forward here, if we have a circumstance where that mistake could be made again, the effort likely will be in the other direction, to provide liquidity to the system. You're not going to see banks fail. You're not going to see large financial institutions fail. The Fed will back the system with every dollar that it can print. But of course all that would go on top of what is already an uncontrolled federal deficit. The end result, when it does all come together, will be something akin to a hyperinflation, but at the same time you'll have also a very depressed economy. So there'll

be an inflationary recession, which I think we're already beginning to get into, that possibly could evolve into a hyperinflationary depression, as much as I really hate to use that term. I am an optimist at heart. I'm not a perennial bear.

Could have fooled me.

Well, no one has mistaken me for a perennial bull for awhile, but if there's any way of getting around this–and I'm looking for ways for it to happen–I just don't see it. I mean, if we can accept for a moment my premise that there's no way of curing the fiscal problem shy of a bankruptcy–and that there's no way the government is going to renege on its debt–I'm sure it'll do what has been politically expedient in the past: You rev up the printing presses and pay off the debt with the money that you print–even as that money becomes worthless. The thing is, with the dollar, we are dealing with the world's reserve currency. So we are talking about a global crisis of unprecedented proportions, probably one that would lead to the collapse of the current currency system. You'd probably have to have an international conference to reconstitute the global currency system and somehow build confidence in the public that the new system will work and that it's stable, so that we are not put in the same position as the poor people of Germany, after WWI, because that is the type of hyperinflation that could evolve here. So the cures will have to be remarkable. They will have to convince people that things have changed. As crazy as it sounds, I think the only thing they will be able to do is to go back on some kind of gold standard.

You're right. It sounds crazy, for myriad reasons.

It would clearly have to be on a much different basis than we had before. But I would not rule out gold coming back into the monetary system down the road here. Again, I'm not looking for all this to come to a head in the next six months. It could be 10 years before this blows apart. But what I'm looking at, I know central bankers and people in Washington are also looking at. No one wants to talk about it, but they know about it. So it's interesting to see how they behave around gold. I think, despite the jawboning that happens fairly regularly to try to knock down gold prices, that you're going to find more and more gold ending up in central bank vaults, because that's going to help them in the crisis that follows. I might actually start squirreling a little bit of it away.

In your cave?

Well, I was veering more into the speculative realm. Getting back to basics, the financial system is broken and there's no way I can see it being fixed within the existing political structure–and when when you have a circumstance like that, you don't have a happy ending in the markets. There's going to be a break somewhere so that the system can reset itself. Systems do tend to be self-righting over time, if you don't play with them too much.

On that cheery note, let's step back from the abyss a little and look at the here and now. You've said that, contrary to all the upbeat economic statistics we've seen lately, the U.S. economy is already in a recession?

Yes. What I've found is that if you adjust the real GDP numbers that the government releases for the myriad revisions and redefinitions that have been applied to the measure with increasing frequency since the mid-1980s, you find that there's a happy overstatement of growth of about 3% on a year-over-year basis. Part of that is tied to inflation. Nominal GDP is expressed in today's dollars. That number is then deflated by the BEA's estimate of inflation–so it's important to realize that if inflation is understated, then reported "real" growth will be overstated. The problem here very simply is this: The consumer is the primary driving force behind economic activity and the only ways that consumers can fuel consumption growth are through rising income, debt expansion or savings liquidation–that's where he gets his cash. But the consumer really is not seeing any income growth. Now this is where the playing around with numbers really gets good. We've already talked about hedonics and all the other manipulations of the CPI, but they pale next to the impact of *imputations* in the GDP, which are an outgrowth of the theoretical structure of the national income accounts. Any benefit a person receives has an imputed income component. If you're a homeowner, the government assumes that you pay yourself rent on your house, so that's rental income. If you go to a bank and the bank doesn't charge you any fee for your checking account, that's counted as imputed interest income. When the government puts all of its imputations into "income" its growth generally remains positive–and has very little relationship to reality. Imputed interest income, for instance, accounted for 21% of all personal interest income in 2002, and was growing at an annual rate of over 8%. Meanwhile, fully 62% of total rental income that year was the imputed variety.

Sounds like an enormous fudge factor.

Well, there is a crosscheck to those numbers to a certain extent with the Internal Revenue Service, although their reporting isn't exactly what you would call timely. But generally what the IRS has shown lately–for the first time since World War II–is that income has been dropping. Likewise, when you look at the government's poverty report, you see that average household income is dropping. Forget the games that they're playing with the GDP for a minute. The average household is not seeing any real growth in income; it is not keeping up with inflation. And without growth in income you just can't support growth in personal consumption on a healthy basis, so you do it on an unhealthy basis. You borrow money.

Turn your house into an ATM.

And a lot that has happened. But consumer credit growth has started to slow sharply. There's only so far this can go now that interest rates are backing up, which makes borrowing more expensive. I won't get into all the horrors that people have been talking about–people who bought houses with no money down and short term mortgages who all of a sudden are going to see a sharp spike in mortgage payments as rates rise. But there are cracks visible in consumer debt expansion which suggest perhaps we are not going to see much further economic growth from that source. In fact, it may already be foundering. Then, of course, if you want to look to liquidating savings for spending growth, first you have to have savings. We simply have not had the kind of growth in income that traditionally produces a strong economy for a long time. In fact, real average weekly earnings peaked in 1975 and have generally been on a downhill slope since. That helps explain why today most families have to have two or more people working to make ends meet. This declining standard of living is a long-term problem; it represents a structural shift in the economy that has a lot to do with the trade deficit, the export of our productive capacity, the draining of assets abroad and such. When it comes down to it, Mr. Greenspan fueled the remarkable credit and stock market expansions of the 1990s, which turned into bubbles, because he knew that there was a basic problem in the consumer not having adequate income to sustain economic growth from more traditional sources; he used the stock market to try to fuel the economy.

With notable success.

Temporarily. It got to the point where the perceived wealth effect, particularly in some of the more crazy times before the Nasdaq bubble burst, was over the top. I remember hearing stories about local dentists saying, "Gee, why should I bother to drill teeth? I can make more money in 20 minutes on the phone with my broker than I can by filling teeth all day." But that is not a sustainable circumstance–even if there were a lot of people who thought it was at the time. When that bubble burst, without a foundation of strong income growth, or a financially sound consumer, it triggered a recession that was a lot longer and deeper than the government would have you believe. In fact, I contend that what we are in now is a protracted structural change that goes back to the beginning of that 2000 recession, which eventually may be recognized as a double-dip downturn. We did have some recovery in 2003, but in 2005, you started to see signs of a downturn in a variety of leading indicators that I use.

Such as?

Ones like the money supply, for example, which is very good at signaling downturns. If you take out inflation, real money supply is contracting year-over-year. That is a solid sign that you've got a recession or you're going to have one shortly and we saw that back at mid-year. Since then, the Fed has started to pump up money supply, and M3 in particular has been growing quite rapidly, year over year growth in it is up to about 8% now. But that doesn't always work in reverse; it can be the proverbial pushing on a string. And M2 is still growing at about 4% which is borderline, considering the current CPI, in terms of showing no *real* growth.

Well, the government's first reading on fourth quarter GDP *was* just 1.1%–

Here I've been doing all this talking and writing about how they seemed to be targeting being able to report about 3% growth every quarter and then they came out with that, knocking all my theories to hell! It was less than half the consensus outlook. All the reasons they gave for it were right in tune with a slowing, and with what I would expect. Consumption was down, the trade deficit was taking a bigger bite out the economy. But what puzzled me was why the government *reported* it that way. As I have indicated, they have so much flexibility in the ways they come up with those numbers, particularly when they're doing their first estimate of GDP. It's really a guesstimate, so few of the numbers behind it are hard. Maybe it was just some momentary political lapse that produced an unusual degree of candor in the report. But I might also guess that their first pass at coming up with that number probably produced estimated fourth quarter growth of even *less* than the 1.1% they reported. If so, their first revision of that number will likely turn out to be downward, which would say, to me, at least, that for some reason they're giving us about as straight a GDP report as they can. Now, it's still routinely overstated, as I said earlier, by about 3%, so that 1.1% growth was probably close to 2% contraction. Clearly, the consumer doesn't have the strength to keep this economy pumping at this time.

That's why business capital spending is expected to kick in here and pick up any slack.

Right. But which businesses are going to be picking up their spending here? The auto industry? Sure, there is some investment coming from abroad, but I still remember the days when what was good for General Motors was good for America–and GM is having a very tough time. If we're in a recession, as I think we are, it will show up in a couple of ways, and fairly soon. For one, GM soon won't be the only company feeling a pinch, corporate profits overall should start to fall off over the next six months, as should federal tax receipts, confirming the recession.

So you expect interest rates to fall?

Well, there are a lot of crosscurrents affecting rates here. Under normal circumstances, the inflation that is coming into the system through higher oil prices would be spiking long-term interest rates, but it is not. However, the reason that you're not seeing long-term interest rates rising is *not* because bond investors are anticipating a weakening in the economy, it's because of the strong demand for Treasury securities by foreign investors. The catch is that demand like that can turn overnight. If I were looking for one factor here to signal the onset of some really serious problems, I would watch the dollar. If you start to see a sharp sell off, or if selling starts to pick up a little steam and begins to look a little bit like a panic, or if you start to hear talk of maybe an Asian country dumping a little extra in the way of dollars, it will be a sign of some really bad times to come. Because what will happen in the process is that the liquidity in our system will tend to dry up. There suddenly will be an excess supply of Treasuries on the market and you'll see a sharp spike in interest rates, along with a sharp spike in inflation–despite the weakness in the economy.

The worst of all possible worlds. But suppose we avoid Armageddon for a while?

I still think you'll see the dollar down 10% to 20% from where it is today, on a trade weighted basis. I think the pound and the Swiss franc will be shining stars against the dollar. The euro has some problems as does the yen, but they will rise as well.

And the metals? They are awfully high already–

True, and they can be quite volatile. But there are reasons that the metals are awfully high. I am not the only person out here saying that there is something awry with the system here. This is not normal. This does not have a happy, easy ending. You see the problems with the oil, you see the political risks. Part of what you're seeing in gold is a reaction to what is beginning to unfold here.

Is there no way you can conceive of anything approaching a happy ending?

Oh, there is a happy ending. I just don't see much that could be done at this juncture for the whole system. The good news is that individuals or institutions that recognize what is happening can take action to protect themselves. If you're able to somehow protect your assets and liquidity through the very rough times ahead, you're going to have some of the greatest investment opportunities that anyone has ever seen.

Such a comfort. Thanks, John.