How the government manufactures low inflation

Some government data suggest computer and car prices, among many other things, are falling. But when was the last time you paid less for a car? Here's why you should be concerned.

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By Bill Fleckenstein

Please join me this week in a trip to the government department responsible for fun with numbers. Those D.C. statisticians may churn out their work with a straight face, but that doesn't mean we have to fall for it. Among the skeptics are Steve Milunovich of Merrill Lynch, Jim Grant of Grant's Interest Rate Observer, and, of course, yours truly.

In a recent report, Milunovich noted that the Bureau of Economic Analysis (BEA), whose job it is to compute the Gross Domestic Product each quarter, has "stopped reporting the real computer hardware shipment figure used to calculate real GDP growth, though it is still used in GDP calculations." The BEA, which is part of the Commerce Department, made this readjustment because it is "concerned the rapid price declines for computers made the figures misleading."

Let's stop and review the bidding for a second. Remember: GDP is the measure of goods and services produced in this country. The government decided that certain of its data series involved in calculating GDP were misleading. So, what did it do? Simply stop breaking them out. Makes sense to me; how about you?

This would be a humorous window into the lunacy of government calculations, were it not so important to many statistics. Regular readers of my daily column know that the magic of "hedonics" and all its attendant distortions is something that I have railed about for a long time.

Hedonics: 'miracle' tonic for an ailing economy

For those of you who don't know, hedonics is the way the government transforms price declines into quality improvements. To wit, you buy a PC with twice as much power, so the government concludes that you really paid only half as much money for it. Hedonics is also the government's way of taking quality improvements and converting them into price declines when calculating the CPI. Sure, that brand-new Chevy you just bought cost 40% more than it used to, but it's a 40%-better car for a variety of reasons. So, the government says, the price didn't really go up. (I have oversimplified these examples, but you get the point.)

The idea behind the first case at least makes some sense, though the government carries it too far by acting as though improvements can be precisely measured. The problem with the second case is that those quality improvements are not voluntary. Since you have to pay the new price, it's sheer silliness to say that the price really didn't go up.

There are other ramifications as well. It turns out that the computer-spending component has materially warped GDP calculations in many of the last eight quarters. To put the numbers into perspective, from the second quarter of 2000 through the fourth quarter of 2003, the government estimated that real tech spending rose from $446 billion to $557 billion, when nominal spending only increased to $488 billion. That extra $72 billion represents the value the government imagines the improvement in computer quality is worth.

Now $72 billion doesn't sound like a huge amount in a $10 trillion economy, but at the margin, it makes a difference. And in fact, the contribution of this tech component to real GDP comprised about 12% of growth in the third quarter of 2003 and more than 30% of growth in the first quarter of 2003, i.e., a big chunk of the growth. Since real growth is a factor in the calculation of productivity and productivity growth, these statistics are also distorted.

Slippery CPI, iffy TIPs

Our government has admitted its Alice in Wonderland hedonic-adjustment exercise has produced numbers so distorted that it doesn't want to show them to you. Yet it continues to use the "analysis" and some of the data in calculations of real GDP, productivity growth and CPI calculations. This is one of the reasons I've never been a big fan of Treasury Inflation-Protected Securities, or TIPS. I have stated a million times that the government's calculated cost of inflation, in the form of the CPI, is a joke. So, I refuse to buy a security that's indexed to the CPI, unless the price of the security reflects my skepticism. TIPS may be better than straight bonds, but they're not as good as most people think. As you can see from these two examples, the government aims to cheat you in the calculation, and besides, TIPS don't protect you from a decline in the value of the dollar.

Grant on BEA balderdash

Further reason to be suspicious of all government data comes from the current issue of Grant's Interest Rate Observer, in which the ever-alert Jim Grant broke the story that "the Bureau of Economic Analysis is weighing a study to explore the merits of adjusting the prices of medical services for quality changes."

In other words, the BEA is considering the use of hedonics to lower the impact of rising medical costs on the CPI by subtracting the imagined value of quality improvements in medical care from the price we're really paying. The government recognizes it has a problem with exploding health costs and is studying the use of that same quick fix which has "worked" when unwelcome rising prices have been an issue in other areas, i.e., to *define* the problem away. I would imagine that when the folks at AARP and organized labor find this out, they'll be up in arms. Maybe their clout can stop this nonsense before it gets even worse.

Take heed, enjoins Sir John

On a final note, I would like to share with readers a rather interesting comment that John Templeton, founder of the Templeton Funds, made to Paul Kangas during a PBS interview last Monday.

Templeton's quote will be instantly recognizable to folks who have read the longstanding header on my Web site, which echoes one of my most fervently held views: "In a social democracy with a fiat currency, all roads lead to inflation." (Readers of the Contrarian Chronicles may also refer back to my Nov. 17 column, "All roads now lead to inflation."

And now for Sir John's wisdom: "All currencies, not only the American dollar, but all currencies, always go down, mainly because of democracy. The voters will vote for a person who is going to spend too much, and so you have to expect all currencies to go down." In future columns, I'll have more to say about the dollar, the variables affecting it and why this should be of concern to you.

All roads lead to inflation

Note to the Fed: Rather than perch on your crow's nest looking out for deflation, cut the juice from your money-printing machine to stave off incipient inflation.

Posted 11/17/2003

By Bill Fleckenstein

Now that the hoopla surrounding the Nov. 7 employment number has subsided, I'd like to take advantage of this quiet time to put the results into perspective.

First off, let me take a step back. For my entire career, I always have believed that monetary stimulus "works." Throughout the Greenspan reign, I have believed that the Fed would print as much money as was required to try to make things better. Consistent with those two points, I always have believed that in a social democracy with a fiat currency, all roads lead to inflation. But since the bursting of the biggest bubble in the history of the world, I have been dubious about the ability of stimulus to work its magic in any sustainable way, because of the excess capacity and the misallocation of capital produced by the mania.

As we all know, the combination of a) monetary/fiscal stimulus, and b) the housing market's ability to stage a mini-mania in the post-bubble period conspired to give us a better quarter in the third quarter than I had expected. Now it seems that the job situation might not have been as bleak as it previously appeared (even though corporate America still is laying people off), because of all the stimulus. The economy has gone through a burst of strength. Expectations now place it on the path toward a self-sustaining recovery.

Nevertheless, I do not share those expectations, nor do I accept the innards of the employment number as gospel. Though space does not permit me to reprise the skepticism of some wise commentators who sliced and diced the employment data, I'd like to pass along the following from the UPI news service, published last Tuesday:

> "The next real job boom will occur in 2008, according to the international outplacement firm Challenger, Gray & Christmas. The 2008 job boom will likely come either in health care, such as biotechnology or genetics, or in international business. The job creation during this economic

cycle, however, will not take place in the United States, but in China, India and the Philippines, the beneficiaries of our outsourcing, Challenger, Gray & Christmas said."

Greenspan grills double-edged swordfish

In the not-too-distant future, we will find out if the stimulus-engendered economic strength fizzles, as is my expectation. However, what if it doesn't fizzle right away? Then what? Well, folks who've been counting on economic strength to save the day are going to learn that all is not rosy, even if we head down that path.

I have given the possible outcome of that scenario short shrift because I felt that the idea of more strength for a few quarters was less likely. It could happen, however. The path woven by the stock market, the bond market, the currency markets, the metals markets and certain industries would be different than if we just fizzled. However, in terms of the stock market, the ultimate outcome would be the same: lower prices. In the short run, stock prices obviously can go where they want, but, at some point, they will return to a tighter relationship with the underlying businesses.

As to what a stronger economy might portend, financier George Soros has said that he expects the recovery to abort. Why? Because we'll wind up with higher rates at a time when we are very dependent on *massive* stimulus and *extremely* low rates. Perversely, an improved economy could trigger an ugly outcome sooner, as higher rates could really wreak havoc in the housing market and all the debt outstanding.

That will slow the economy, and then we'll lapse into recession. We saw a variation of this stop-go economic action in the 1970s -- and wound up dealing with a whole lot of inflation.

We should admit our mistakes

The bottom line is, we are in a box because we had a mania. Post-mania, the best possible behavior would have been to admit our mistakes, let the markets clear, clean up the dead wood, hunker down for a while, and create the foundation for a long-lived recovery. The path chosen by the Fed, the government and, apparently, most people was to pretend the mania didn't happen, and try to power past it, still believing in the tooth fairy. This has caused only further misallocations of capital and other problems that will have to be sorted out prospectively. The idea that a short and sweet recession could close the book on our epic bubble is strictly a fairy tale.

Investing takes a backseat to insanity

Meanwhile, bubblelike behavior has been giving a good account of itself on Wall Street. Consider what transpired after **Cisco Systems** (CSCO, news, msgs) released its third-quarter results after the market closed on Nov. 5.

Almost immediately after folks learned that Cisco had won at "beat the number," the stock was up 5%. Some $10 billion -- or two quarters' worth of revenue, to put that into perspective -- were added to Cisco's market cap as fans cheered the veneer covering less than earth-moving results.

I could cite hundreds of additional examples of ludicrous prices, but you get the point. That is what passes for investment rigor in this bubblelike environment. As we learned in the late 1998-early 2000 period, just because something is ludicrous doesn't mean it can't get even wilder.

Craziness is not a sufficient catalyst to end the party. Speculative fervor has survived all the crookedness on the part of Wall Street, corporate America, the mutual funds, and the asleep-at-the-switch-ness on the part of top brass at the NYSE and SEC. But as we learned in the last go-round, this will end painfully for most people. The only questions we face are: When will we pay, in what way, and who will feel the burden most?