

Hard numbers: The economy is worse than you know

By Kevin Phillips, Harper's Magazine

In print: Sunday, April 27, 2008

Ever since the 1960s, Washington has gulled its citizens and creditors by debasing official statistics, the vital instruments with which the vigor and muscle of the American economy are measured..

The effect has been to create a false sense of economic achievement and rectitude, allowing us to maintain artificially low interest rates, massive government borrowing, and a dangerous reliance on mortgage and financial debt even as real economic growth has been slower than claimed.

The corruption has tainted the very measures that most shape public perception of the economy:

- The monthly Consumer Price Index (CPI), which serves as the chief bellwether of inflation;
- The quarterly Gross Domestic Product (GDP), which tracks the U.S. economy's overall growth;
- The monthly unemployment figure, which for the general public is perhaps the most vivid indicator of economic health or infirmity.

Not only do governments, businesses and individuals use these yardsticks in their decisionmaking, but minor revisions in the data can mean major changes in household circumstances — inflation measurements help determine interest rates, federal interest payments on the national debt, and cost-of-living increases for wages, pensions and Social Security benefits.

And, of course, our statistics have political consequences too. An administration is helped when it can mouth banalities about price levels being "anchored" as food and energy costs begin to soar.

The truth, though it would not exactly set Americans free, would at least open a window to wider economic and political understanding. Readers should ask themselves how much angrier the electorate might be if the media, over the past five years, had been citing 8 percent unemployment (instead of 5 percent), 5 percent inflation (instead of 2 percent), and average annual growth in the 1 percent range (instead of the 3-4 percent range).

Let me stipulate: The deception arose gradually, at no stage stemming from any concerted or cynical scheme. There was no grand conspiracy, just accumulating opportunisms.

The political blame for the slow, piecemeal distortion is bipartisan — both Democratic and Republican administrations had a hand in the abetting of political dishonesty, reckless debt and a casino-like financial sector. To see how, we must revisit 40 years of economic and statistical dissembling.

Pollyanna Creep

"Pollyanna Creep" is an apt phrase that originated with John Williams, a California-based economic analyst and statistician who "shadows," as he puts it, the official Washington numbers. In a 2006 interview, Williams noted that although few Americans ever see the fine print, the government "always footnotes the changes and provides all the fine detail. Nonetheless, some of the changes are nothing short of remarkable, and the pattern over time is what I call Pollyanna Creep."

Williams is one of the small group of economists and analysts who have paid any attention to the phenomenon. A few have pointed out the understatement of the Consumer Price Index — the billionaire bond manager Bill Gross has described it as an "haute con job." In 2003, a University of Chicago economist named Austan Goolsbee (now a senior economic adviser to Barack Obama's presidential campaign) published an op-ed in the *New York Times* pointing out how the government had minimized the depth of the 2001-2002 U.S. recession, having "cooked the books" to misstate and minimize the unemployment numbers.

Unfortunately, the critics have tended to train their axes on a single abuse, missing the broad forest of statistical misinformation that has grown up over the past four decades.

The story starts after the inauguration of John F. Kennedy in 1961, when high jobless numbers marred the image of Camelot-on-the-Potomac and the new administration appointed a committee to weigh changes. The result, implemented a few years later, was that out-of-work Americans who had stopped looking for jobs — even if this was because none could be found — were labeled "discouraged workers" and excluded from the ranks of the unemployed, where many, if not most, of them had been previously classified.

By the 1969 fiscal year, Lyndon Johnson orchestrated a "unified budget" that combined Social Security with the rest of the federal outlays. This innovation allowed the surplus receipts in the former to mask the emerging deficit in the latter.

Richard Nixon, besides continuing the unified budget, developed his own taste for statistical improvement. He asked his second Federal Reserve chairman, Arthur Burns, to develop what became an ultimately famous division between "core" inflation and headline inflation. If the Consumer Price Index was calculated by tracking a bundle of prices, so-called core inflation would simply exclude, because of "volatility," categories that happened to be troublesome: at that time, food and energy.

Core inflation could be spotlighted when the headline number was embarrassing, as it was in 1973 and 1974. (The economic commentator Barry Ritholtz has joked that core

inflation is better called "inflation ex-inflation" — i.e., inflation after the inflation has been excluded.)

In 1983, under the Reagan administration, inflation was further finagled when the Bureau of Labor Statistics (BLS) decided that housing, too, was overstating the Consumer Price Index; the BLS substituted an entirely different "Owner Equivalent Rent" measurement, based on what a homeowner might get for renting his or her house. This methodology, controversial at the time but still in place today, simply sidestepped what was happening in the real world of homeowner costs.

Because low inflation encourages low interest rates, which in turn make it much easier to borrow money, the BLS's decision no doubt encouraged, during the late 1980s, the large and often speculative expansion in private debt — much of which involved real estate, and some of which went spectacularly bad between 1989 and 1992 in the savings-and-loan, real estate and junk-bond scandals.

The distortional inclinations of the next president, George H.W. Bush, came into focus in 1990, when Michael Boskin, the chairman of his Council of Economic Advisers, proposed to reorient U.S. economic statistics principally to reduce the measured rate of inflation. His stated grand ambition was to move the calculus away from old industrial-era methodologies toward the emerging services economy and the expanding retail and financial sectors. Skeptics, however, countered that the underlying goal, driven by worry over federal budget deficits, was to reduce the inflation rate in order to reduce federal payments — from interest on the national debt to cost-of-living outlays for government employees, retirees, and Social Security recipients.

Hidden unemployed

It was left to the Clinton administration to implement these convoluted CPI measurements, which were reiterated in 1996 through a commission headed by Boskin and promoted by Federal Reserve Chairman Alan Greenspan.

The Clintonites also extended the Pollyanna Creep of the nation's employment figures. In 1994, the Bureau of Labor Statistics redefined the work force to include only that small percentage of "discouraged workers" who had been seeking work for less than a year. The longer-term discouraged — some 4-million U.S. adults — fell out of the main monthly tally. Some now call them the "hidden unemployed."

For its last four years, the Clinton administration also thinned the monthly household economic sampling by one sixth, from 60,000 to 50,000, and a disproportionate number of the dropped households were in the inner cities; the reduced sample (and a new adjustment formula) is believed to have reduced black unemployment estimates and eased worsening poverty figures.

Despite the present Bush administration's overall penchant for manipulating data (e.g., Iraq, climate change), it has yet to match its predecessor in economic revisions. In 2002,

the administration did introduce an "experimental" new CPI calculation (the C-CPI-U), which shaved another 0.3 percent off the official CPI; and since 2006 it has stopped publishing the M-3 money supply numbers, which captured rising inflationary impetus from bank credit activity.

After 40 years of manipulation, more than a few measurements of the U.S. economy have been distorted beyond recognition.

Untruth in labeling

Last year, the word "opacity," hitherto reserved for Scrabble games, became a mainstay of the financial press. A credit market panic had been triggered by something called collateralized debt obligations (CDOs), which in some cases were too complicated to be fathomed even by experts. The packagers and marketers of CDOs were forced to acknowledge that their hypertechnical securities were fraught with "opacity" — a convenient and legally judgment-free word for lack of honest labeling.

Exotic derivative instruments with alphabet-soup initials command notional values in the hundreds of trillions of dollars, but nobody knows what they are really worth. Some days, half of the trades on major stock exchanges come from so-called black boxes programmed with everything from binomial trees to algorithms; most federal securities regulators couldn't explain them, much less monitor them.

Transparency is the hallmark of democracy, but we now find ourselves with economic statistics every bit as opaque — and as vulnerable to double-dealing — as a subprime CDO.

Of the "big three" statistics, let us start with unemployment. Most of the people tired of looking for work, as mentioned above, are no longer counted in the work force, though they do still show up in one of the auxiliary unemployment numbers.

The BLS has six different regular jobless measurements — U-1, U-2, U-3 (the one routinely cited), U-4, U-5, and U-6. In January 2008, the U-4 to U-6 series produced unemployment numbers ranging from 5.2 percent to 9.0 percent, all above the "official" number.

The series nearest to real-world conditions is, not surprisingly, the highest: U-6, which includes part-timers looking for full-time employment as well as other members of the "marginally attached," a new catchall meaning those not looking for a job but who say they want one. Yet this does not even include the Americans who (as Austan Goolsbee put it) have been "bought off the unemployment rolls" by government programs such as Social Security disability.

Second is the Gross Domestic Product, which in itself represents something of a fudge: Federal economists used the Gross National Product until 1991, when rising U.S. international debt costs made the narrower GDP assessment more palatable. The GDP

has been subject to many further fiddles, the most manipulatable of which are the adjustments made for the presumed starting up and ending of businesses (the "birth/death of businesses" equation) and the amounts that the Bureau of Economic Analysis "imputes" to nationwide personal income data (known as phantom income boosters, or imputations; for example, the imputed income from living in one's own home, or the benefit one receives from a free checking account, or the value of employer-paid health- and life-insurance premiums).

During 2007, imputed income accounted for some 15 percent of GDP. John Williams, the economic statistician, is briskly contemptuous of GDP numbers over the past quarter century. "Upward growth biases built into GDP modeling since the early 1980s have rendered this important series nearly worthless," he wrote in 2004. "(T)he recessions of 1990/1991 and 2001 were much longer and deeper than currently reported (and) lesser downturns in 1986 and 1995 were missed completely."

Nothing, however, can match the tortured evolution of the third key number, the somewhat misnamed Consumer Price Index. Government economists themselves admit that the revisions during the Clinton years worked to reduce the current inflation figures by more than a percentage point, but the overall distortion has been considerably more severe. Just the 1983 manipulation, which substituted "owner equivalent rent" for home-ownership costs, served to understate or reduce inflation during the recent housing boom by 3 to 4 percentage points.

Moreover, since the 1990s, the CPI has been subjected to three other adjustments, all downward and all dubious: product substitution (if flank steak gets too expensive, people are assumed to shift to hamburger, but nobody is assumed to move up to filet mignon), geometric weighting (goods and services in which costs are rising most rapidly get a lower weighting for a presumed reduction in consumption), and, most bizarrely, hedonic adjustment, an unusual computation by which additional quality is attributed to a product or service.

The hedonic adjustment, in particular, is as hard to estimate as it is to take seriously. No small part of the condemnation must lie in the timing.

If quality improvements are to be counted, that count should have begun in the 1950s and 1960s, when such products and services as air-conditioning, air travel, and automatic transmissions — and these are just the A's! — improved consumer satisfaction to a comparable or greater degree than have more recent innovations. That the change was made only in the late '90s shrieks of politics and opportunism, not integrity of measurement.

Most of the time, hedonic adjustment is used to reduce the effective cost of goods, which in turn reduces the stated rate of inflation. "All in all," Williams points out, "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 percent to 4 percent higher" — meaning that, because of

lost CPI increases, Social Security checks would be 70 percent greater than they currently are.

Furthermore, when discussing price pressure, government officials invariably bring up "core" inflation, which excludes precisely the two categories — food and energy — now verging on another 1970s-style price surge.

Numbers that crunch

The real numbers, to most economically minded Americans, would be a face full of cold water. Based on the criteria in place a quarter century ago, today's U.S. unemployment rate is somewhere between 9 percent and 12 percent; the inflation rate is as high as 7 or even 10 percent; economic growth since the recession of 2001 has been mediocre, despite a huge surge in the wealth and incomes of the superrich, and we are falling back into recession.

If what we have been sold in recent years has been delusional "Pollyanna Creep," what we really need today is a picture of our economy ex-distortion. For what it would reveal is a nation in deep difficulty not just domestically but globally.

Undermeasurement of inflation, in particular, hangs over our heads like a guillotine. To acknowledge it would send interest rates climbing, and thereby would endanger the viability of the massive buildup of public and private debt (from less than \$11-trillion in 1987 to \$49-trillion last year) that props up the American economy. Moreover, the rising cost of pensions, benefits, borrowing, and interest payments — all indexed or related to inflation — could join with the cost of financial bailouts to overwhelm the federal budget.

Arguably, the unraveling has already begun. As Robert Hardaway, a University of Denver professor, pointed out last fall, the subprime lending crisis "can be directly traced back to the (1983) BLS decision to exclude the price of housing from the CPI. ... With the illusion of low inflation inducing lenders to offer 6 percent loans, not only has speculation run rampant on the expectations of ever-rising home prices, but home buyers by the millions have been tricked into buying homes even though they only qualified for the teaser rates."

Were mainstream interest rates to jump into the 7 to 9 percent range — which could happen if inflation were to spur new concern — both Washington and Wall Street would be walking in quicksand. The make-believe economy of the past two decades, with its asset bubbles, massive borrowing, and rampant data distortion, would be in serious jeopardy.

The credit markets are fearful, and the financial markets are nervous. If gloom continues, our humbugged nation may truly regret losing sight of history, risk and common sense.

*Kevin Phillips' new book, Bad
Money: Reckless Finance, Failed
Politics and the Global Crisis of
American Capitalism, was published last month by Viking.*