"Government Economic Reports: Things You've Suspected but Were Afraid to Ask! -- The Consumer Price Index" - Sep. 22, 2004

Introduction

When it comes to government economic data, it is easy to get terribly confused. In recent years, it also has become easy to be more and more suspicious of the numbers themselves.

In his guest series, of which this is the third installment, friend and client, Walter J. "John" Williams, helps clear up much of the confusion. We doubt, though, that readers will find this to be the case with regard to the suspicion!

We published the first installment in this series, "Employment and Unemployment Reporting," on 8/24. The second installment, "Federal Deficit Reality," appeared on 9/7. Both drew immense interest. We believe readers will find the current offering, "The Consumer Price Index," equally interesting and provocative. Here's a taste of what the article contains:

"Changes made in CPI methodology during the Clinton administration have understated inflation significantly, and, through a cumulative effect, have reduced current social security payments by 30% from where they would have been otherwise. That means Social Security checks would be 43% higher. In like manner, anyone involved in commerce, who relies on receiving payments adjusted for the CPI, has been similarly damaged. On the other side, if your are making payments based on the CPI (i.e., the federal government), you are making out like a bandit."

John has a long, distinguished record of following and critiquing the changes occurring over the years in the government's reporting of the economic numbers that can and do influence our lives in a major way. In addition to today's and the earlier articles, we will publish one more installment, dealing with gross domestic product. To state that what people observe in today's GDP data seems to have become a little "mystifying" is to engage in significant understatement!

John has again agreed to field any questions or comments this piece generates. You will find this invitation at the conclusion of the article.

The first installment included an introduction section intended to serve that function for the entire series; it was labeled "Series Introduction." It contained a great deal of key definitional material and was highly enlightening in its own right.

For convenience and reference purposes, this section is repeated in the current material, found at the conclusion of the installment. If you have not yet had a chance to read the "Series Introduction," you might want to have a look it before reading the current or prior installments.

John Williams joins a growing list of guest contributors who have provided some terrific material in the short time the GRA website has been in existence. When you have a moment, go to the website's "Guest Contributions" section on the home page (www.gillespieresearch.com/, lower right-hand column) and peruse some of the other work available there. Incidentally, if you did not read the earlier installments of John's series, you will find them posted in the "Guest Contributions" section. --Doug Gillespie

NOTE: The opinions expressed in this material do not necessarily reflect the views of Gillespie Research Associates.

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"GOVERNMENT ECONOMIC REPORTS: THINGS YOU'VE SUSPECTED BUT WERE AFRAID TO ASK! -- THE CONSUMER PRICE INDEX"
(Part Three in a Series)

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Foreword

The source for most of the information this installment is the Bureau of Labor Statistics, which generally has been very open about its methodologies and changes to same. The BLS Web site: www.bls.gov contains descriptions of the CPI and its related methodologies. Other sources include my own analyses of the CPI data and methodological changes over the last 30 years as well as interviews with individuals involved in inflation reporting.

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Payments to Social Security Recipients Should be 43% Higher

Inflation, as reported by the Consumer Price Index (CPI) is understated by roughly 2.7% per year. This is due to recent redefinitions of the series as well as to flawed methodologies, particularly adjustments to price measures for quality changes. The concentration of this installment on the quality of government economic reports will be first on CPI series redefinition and the damages done to those dependent on accurate cost-of-living estimates, and on pending further redefinition and economic damage.

The CPI was designed to help businesses, individuals and the government adjust their financial planning and considerations for the impact of inflation. The CPI worked reasonably well for those purposes into the early-1990s. In recent years, however, the reporting system has succumbed to pressures from miscreant politicians, who were and are intent upon stealing income from social security recipients, without ever taking the issue of reduced entitlement payments before the public or Congress for approval.

Changes made in CPI methodology during the Clinton administration have understated inflation significantly, and, through a cumulative effect, have reduced current social security payments by 30% from where they would have been otherwise. That means Social Security checks would be 43% higher. In like manner, anyone involved in commerce, who relies on receiving payments adjusted for the CPI, has been similarly damaged. On the other side, if your are making payments based on the CPI (i.e., the federal government), you are making out like a bandit.

Elements of the Consumer Price Index (CPI) had their roots in the mid-1880s, when the Bureau of Labor, later known as the Bureau of Labor Statistics (BLS), was asked by Congress to measure the impact of new tariffs on prices. It was another three decades, however, before price indices would be combined into something resembling today's CPI, a measure used then for setting wage increases for World War I shipbuilders. Although published regularly since 1921, the CPI did not come into broad acceptance and use until after World War II, when it was included in auto union contracts as a cost-of-living adjustment for wages.

The CPI found its way not only into other union agreements, but also into most commercial contracts that required consideration of cost/price changes or inflation. The CPI also was used to adjust Social Security payments annually for changes in the cost of living, and therein lay the eventual downfall to the credibility of CPI reporting.

Let Them Eat Hamburger

In the early 1990s, press reports began surfacing as to how the CPI really was significantly overstating inflation. If only the CPI inflation rate could be reduced, it was argued, then entitlements, such as social security, would not increase as much each year, and that would help to bring the budget deficit under control. Behind this movement were financial luminaries Michael Boskin, then chief economist to the first Bush administration, and Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System.

Although the ensuing political furor killed consideration of Congressionally mandated changes in the CPI, the BLS quietly stepped forward and began changing the system, anyway, early in the Clinton administration.

Up until the Boskin/Greenspan agendum surfaced, the CPI was measured using the costs of a fixed basket of goods, a fairly simple and straightforward concept. The identical basket of goods would be priced at prevailing market costs for each period, and the period-to-period change in the cost of that market basket represented the rate of inflation in terms of maintaining a constant standard of living.

The Boskin/Greenspan argument was that when steak got too expensive, the consumer would substitute hamburger for the steak, and that the inflation measure should reflect the costs tied to buying hamburger versus steak, instead of steak versus steak. Of course, replacing hamburger for steak in the calculations would reduce the inflation rate, but it represented the rate of inflation in terms of maintaining a declining standard of living. Cost of living was being replaced by the cost of survival. The old system told you how much you had to increase your income in order to keep buying steak. The new system promised you hamburger, and then dog food, perhaps, after that.

The Boskin/Greenspan concept violated the intent and common usage of the inflation index. The CPI was considered sacrosanct within the Department of Labor, given the number of contractual relationships that were anchored to it. The CPI was one number that never was to be revised, given its widespread usage.

Shortly after Clinton took control of the White House, however, attitudes changed. The BLS initially did not institute a new CPI measurement using a variable-basket of goods that allowed substitution of hamburger for steak, but rather tried to approximate the effect by changing the weighting of goods in the CPI fixed basket. Over a period of several years, straight arithmetic weighting of the CPI components was shifted to a geometric weighting. The Boskin/Greenspan benefit of a geometric weighting was that it automatically gave a lower weighting to CPI components that were rising in price, and a higher weighting to those items dropping in price.

Once the system had been shifted fully to geometric weighting, the net effect was to reduce reported CPI on an annual, or year-over-year basis, by 2.7% from what it would have been based on the traditional weighting methodology. The results have been dramatic. The compounding effect since the early-1990s has reduced annual cost of living adjustments in social security by a total of 30%.

There now are three CPI measures, CPI for All Urban Consumers (CPI-U), CPI for Urban Wage Earners and Clerical Workers (CPI-W) and the Chained CPI-U (C-CPI-U). The CPI-U is the popularly followed inflation measure reported in the financial media. It was introduced in 1978 as a more-broadly-based version of the then existing CPI, which was renamed CPI-W. The CPI-W is used in calculating Social Security benefits. These two series tend to move together and are based on frequent price sampling, which is supposed to yield something close to an average monthly price measure by component.

The C-CPI-U was introduced during the second Bush administration as an alternate CPI measure. Unlike the theoretical approximation of geometric weighting to a variable, substitution-prone market basket, the C-CPI-U is a direct measure of the substitution effect. The difference in reporting is that August 2004 year-to-year inflation rates for the CPI-U and the C-CPI-U were 2.7% and 2.1%, respectively. Hence current inflation still has a 0.6% notch to be taken out of it through methodological manipulation. The C-CPI-U would not have been introduced unless there were plans to replace the current series, eventually.

Traditional inflation rates can be estimated by adding 2.7% to the CPI-U annual growth rate (2.7% +2.7% = 5.4% as of August 2004) or by adding 3.3% to the C-CPI-U rate (2.1% + 3.3% = 5.4% as of August 2004).

Hedonic Thrills of Using Federally Mandated Gasoline Additives

Aside from the changed weighting, the average person also tends to sense higher inflation than is reported by the BLS, because of hedonics, as in hedonism. Hedonics adjusts the prices of goods for the increased pleasure the consumer derives from them. That new washing machine you bought did not cost you 20% more than it would have cost you last year, because you got an offsetting 20% increase in the pleasure you derive from pushing its new electronic control buttons instead of turning that old noisy dial, according to the BLS.

When gasoline rises 10 cents per gallon because of a federally mandated gasoline additive, the increased gasoline cost does not contribute to inflation. Instead, the 10 cents is eliminated from the CPI because of the offsetting hedonic thrills the consumer gets from breathing cleaner air. The same principle applies to federally mandated safety features in automobiles. I have not attempted to quantify the effects of questionable quality adjustments to the CPI, but they are substantial.

Then there is "intervention analysis" in the seasonal adjustment process, when a commodity, like gasoline, goes through violent price swings. Intervention analysis is done to tone down the volatility. As a result, somehow, rising gasoline prices never seem to get fully reflected in the CPI, but the declining prices sure do.

How Can So Many Financial Pundits Live Without Consuming Food and Energy?

The Pollyannas on Wall Street like to play games with the CPI, too. The concept of looking at the "core" rate of inflation-net of food and energy-was developed as a way of removing short-term (as in a month or two) volatility from inflation when energy and/or food prices turned volatile. Since food and energy account for about 23% of consumer spending (as weighted in the CPI), however, related inflation cannot be ignored for long. Nonetheless, it is common to hear financial pundits cite annual "core" inflation as a way of showing how contained inflation is. Such comments are moronic and such commentators are due the appropriate respect.

Too-Low Inflation Reporting Yields Too-High GDP Growth

As will be discussed in the final installment on GDP, part of the problem with GDP reporting is the way inflation is handled. Although the CPI is not used in the GDP calculation, there are relationships with the price deflators used in converting GDP data and growth to inflation-adjusted numbers. The more inflation is understated, the higher the inflation-adjusted rate of GDP growth that gets reported.

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Comments and questions are invited:
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NOTE: To access the prior two installments in this series, to to the "Guest Contributions" section (lower right-hand column) at: www.gillespieresearch.com/.

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Series Introducion (Repeated from Prior Installments)

In 1996 -- the middle of the Clinton economic miracle -- the Kaiser Foundation conducted a survey of the American public that purported to show how out of touch the electorate was with economic reality. Most Americans thought inflation and unemployment were much higher, and economic growth was much weaker, than reported by the government. The *Washington Post* bemoaned the economic ignorance of the public. The same results would be found today.

Neither the Kaiser Foundation nor the *Post* understood that there was and still is good reason for the gap between common perceptions and government reporting: government data are biased in politically correct directions and increasingly have diverged from common experience and reality since the mid-1980s. Inflation and unemployment reports are understated, while employment and other economic data are overstated, deliberately.

For several years, I conducted surveys among business economists as to how they viewed the quality of government economic data. The following were actual comments:

· The senior economist of a major retail company told me, "Quality varies. The retail sales numbers are terrible, but money supply data are great."

· The senior economist at a major bank offered, "There's a problem with money supply, but I think retail sales are pretty good."

The point is that when an economist knows a sector well, he also recognizes the limitations and distortions of related economic reporting. Gathering and reporting accurate information on a timely (one-month) basis for components of the U.S. economy is nearly impossible. Nonetheless, most career government statisticians in Washington work diligently to provide the best information possible within the limits of the existing reporting system. A number of reporting distortions, however, are not accidental.

What follows is brief background on the reporting system and how the numbers can be viewed. Separate installments will address the specifics of employment, inflation, GDP and budget deficit reporting. Other areas will be addressed upon request.

The first regular reporting of now-popular statistics such as gross national/domestic product (GNP/GDP), unemployment and the consumer price index (CPI) began in the decade following World War II. Modern

political manipulation of the government's economic data began as soon as practicable thereafter, with revisions to methodology often incorporating positive reporting biases. As a result, investors and most economists, relying on the government's data, often miss underlying economic reality. Consider:

· During the Kennedy administration, unemployment was redefined with the concept of "discouraged workers" so as to reduce the popularly followed unemployment rate.

· If Lyndon Johnson didn't like the growth that was going to be reported in the GNP, he sent it back to the Commerce Department, and he kept doing so until Commerce got it right. The Johnson administration also was responsible for gimmicking the accounting that hides most of the federal deficit.

· Richard Nixon had a highly publicized war with the Bureau of Labor Statistics on the unemployment data. Nixon wanted to report the unemployment rate as the lower of the seasonally adjusted or unadjusted number, at any given time, but not specify same to the public. While that approach was unconscionable at the time and never used, basically the same methodology was introduced in 2004 as "state-of-the-art" by the current Bush administration.

· The Carter administration was caught deliberately understating inflation.

· Systemic changes were introduced during the Reagan administration to boost reported GNP/GDP growth on a regular basis. The wildest manipulations, however, happened at the time of the 1987 liquidity panic. In addition to intervention in the futures markets by the New York Fed to help prop the stock market after the October 19th crash, direct and heavy manipulation of the trade deficit data, under the direction of the Federal Reserve and U.S. Treasury, was used in conjunction with massive currency intervention to help bottom the dollar and to contain the currency panic at year-end 1987.

· The first Bush Administration began efforts at the systematic reduction of the reported rate of CPI inflation, and worked an outside-the-system GDP manipulation aimed at helping with the failed 1992 reelection bid.

· As former Labor Secretary Bob Reich explained in his memoirs, the Clinton administration had found in its public polling that if the government inflated economic reporting, enough people would believe it to swing a close election. Accordingly, whatever integrity had survived in the economic reporting system disappeared during the Clinton years. Unemployment was redefined to eliminate five million discouraged workers and to lower the unemployment rate; methodologies were changed to reduce poverty reporting, to reduce reported CPI inflation, to inflate reported GDP growth, among others.

· The current Bush administration has expanded upon the Clinton era initiatives, particularly in setting the stage for the adoption of a new and lower-inflation CPI and in further redefining the GDP and the concept of seasonal adjustment.

As a result of the systemic manipulations, if the GDP methodology of 1980 were applied to today's data, the second quarter's annualized inflation-adjusted GDP growth of 3.0% would be roughly three percent lower (effectively netting to zero percent or below). In like manner, current annual CPI inflation is understated by about 2.7% against the pre-Clinton CPI methodology (would be about 5.7%), and the unemployment rate is understated by about seven percent against its original design and what many people would consider to be actual unemployment (would be about 12.5%).

As to the financial results of federal operations, the application of accrual accounting and generally accepted accounting principles to federal operations shows an actual fiscal year 2003 deficit of $3.7 trillion, as reported by the U.S. Treasury, versus the reported cash-basis $374 billion.

Key Factors to Consider with Any Economic Release

Hearing or reading an economic statistic in the financial media is of little value, unless the context of the reported number is clear, detailing the type of change, any inflation adjustment, seasonal adjustment and revisions.

Seasonal Adjustment -- Widely followed data often are adjusted to remove patterns of distortion that recur regularly, year after year, or that are tied to business or trading days. For example, retail sales are strongest during the holiday season; February 2003 had 28 days, February 2004 had 29 days.

While seasonal adjustment is a legitimate tool for enabling month-to-month or quarter-to-quarter comparisons of data that might otherwise be biased by calendar trends, more often than not, the government has problems with its adjustments. Areas that usually do not adjust well: weekly unemployment claims and employment

seasonals related to holidays and the school year.

One way to avoid many seasonality questions is to look at growth on a year-over-year basis, July 2004 versus July 2003, for example. Trends in annual growth are largely free of seasonal distortions.

Seasonal factors typically are calculated annually, based on recent years' patterns of activity. The Bureau of Labor Statistics, however, went to revising and recalculating its employment seasonal factors each month, as of January 2004.

Inflation Adjustment -- If inflation is up 3.0% for the year, and sales are up 2.0% for the year, then sales fell 1.0% after adjustment for inflation. Deflating dollar numbers is a legitimate approach to viewing data with the effects of inflation removed.

Terms that mean data have been adjusted for inflation include *real, constant dollars, in 2000 dollars, in chain weighted 2000 dollars.* Beyond no inflation reference, terms that mean data have not been adjusted include *nominal*, and *current dollars*.

The most popularly followed inflation-adjusted economic statistic is the GDP, which reflects the growth in dollar economic activity minus the growth in inflation. If inflation is understated, which it is, then the resulting real GDP is overstated.

Type of Growth -- Is the reported growth *month-to-month, year-to-year* or *annualized*? Most monthly economic releases are reported showing month-to-month change. Quarterly numbers are shown either with quarter-to-quarter growth (i.e., the Employment Cost Index) or at an annualized rate of change (GDP). (SAAR means seasonally adjusted annualized rate.)

As discussed earlier, more meaningful trends usually are seen in year-to-year change, although such patterns rarely get publicized. Year-to-year change (the way most businesses look at their sales -- How am I doing against last year?) usually eliminates seasonal distortions in unadjusted data or residual seasonal distortions in adjusted data.

Revisions -- Most economic series go through regular and often significant revisions, typically for the next several releases and then annually in some form of a *benchmark revision*, as the government gets better or more complete data. A monthly number can appear to be strong or weak due solely to prior period revisions.

Two series that do not get revised on a not seasonally adjusted basis are the CPI and the unemployment rate, unless a mistake is made or the series is redefined. In such instances, often the new series is not comparable to the old series, but the financial media rarely pay any attention to those details.

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