John Williams'
Shadow Government Statistics
Analysis Behind and Beyond Government Economic Reporting

COMMENTARY NUMBER 467
GDP Revision, Gold Standard

August 29, 2012

GDI at 0.6%, GDP at 1.7%, GNP at 2.2%, All Plus-or-Minus Three Percentage Points

GDP Recovery Remains An Illusion, Based on Understated Inflation

Fiscal Conditions Have to Be in Balance for Gold Standard to Work

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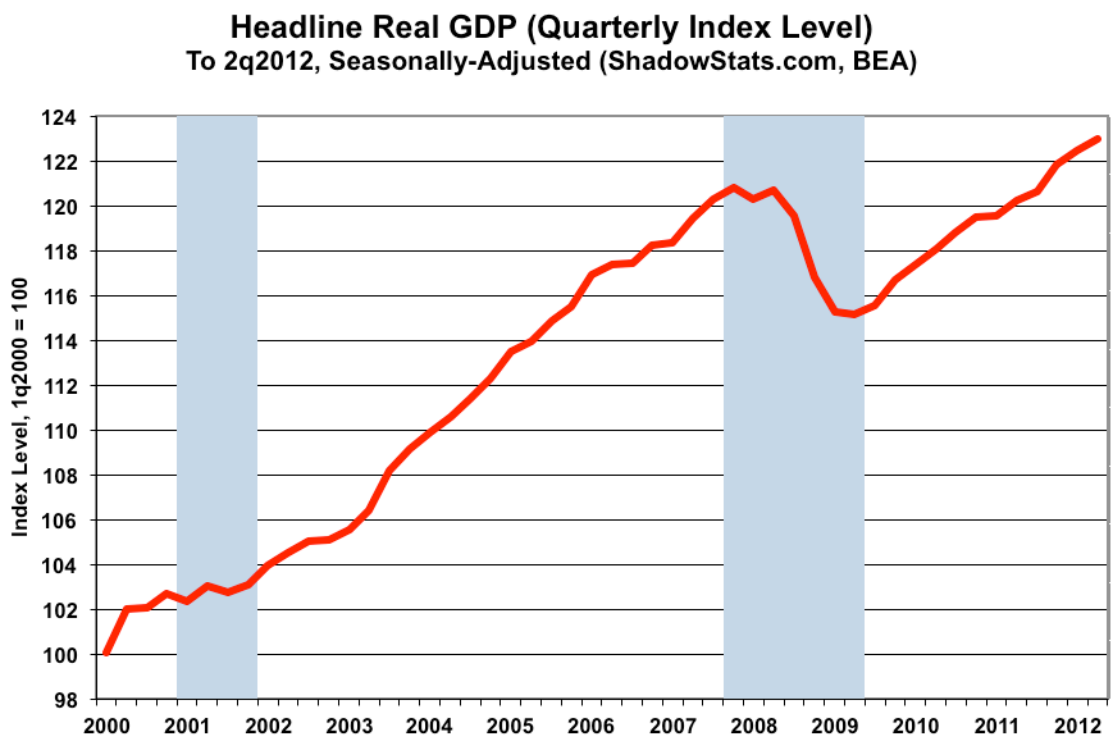
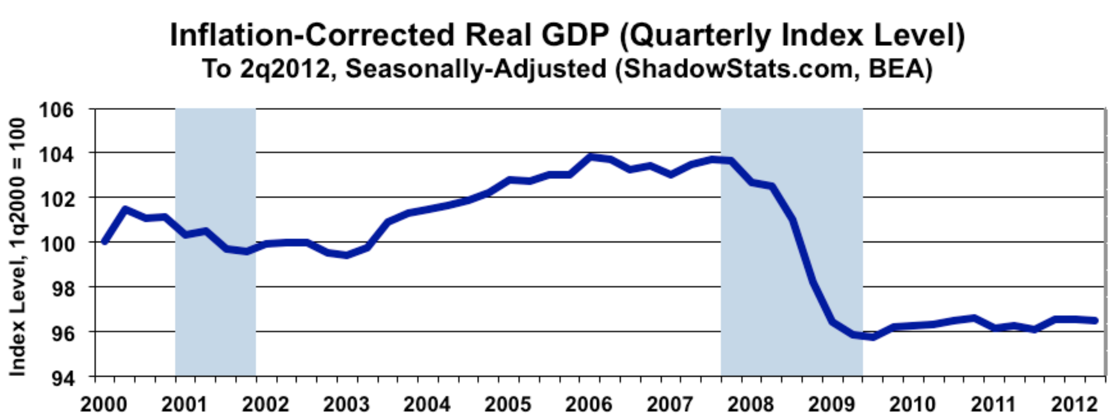
PLEASE NOTE: The next regular Commentary *is scheduled for Friday, September 7th, covering August employment and unemployment, July construction spending and the July PCE deflator.*

Best wishes to all for an enjoyable Labor Day weekend — John Williams

Opening Comments and Executive Summary. The reporting nonsense continued today (August 29th) out of the Bureau of Economic Analysis (BEA), with the first revision to second-quarter GDP and initial estimates of second-quarter GDI and GNP. All the headline growth numbers were statistically insignificant, with the expected GDP revision, 1.5% to 1.7%, being nothing more than minor statistical noise.

Shown in the first graph following, the official level of real (inflation-adjusted) GDP activity has been estimated at above pre-2007 recession levels since fourth-quarter 2011. Still, no other major economic series has shown a parallel pattern of full economic recovery. Instead, as suggested by the second graph following, the full GDP recovery has been nothing more than an illusion created by using too-low a rate of inflation in deflating (removing inflation effects) from the GDP series. When the inflation rate used in deflating a series is understated, the resulting inflation-adjusted series is overstated. The inflation-corrected graph reflects an adjustment removing roughly two percentage points annually of hedonic quality adjustments that have been used to reduce GDP inflation artificially, as discussed in *Hyperinflation 2012*, *Special Report No. 445* and *Public Comment on Inflation*.





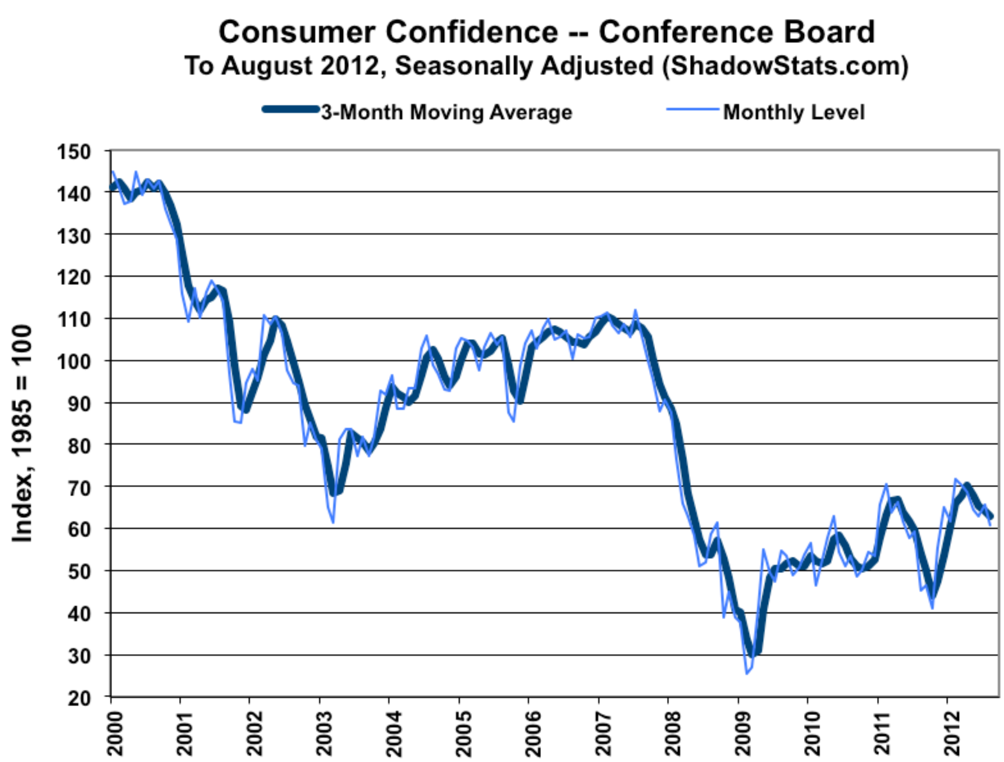
Both of the graphs are indexed to first-quarter 2000 = 100, with the plots to consistent scales.

When good-quality current economic reporting is not available—as is the present circumstance—consideration of the underlying fundamentals is of some value. If the underlying fundamentals are not improving, it is likely that the broad economy also is not improving.

Consider specifically that the individual consumer accounts directly for 73% (personal consumption and residential investment) of the GDP, and indirectly for much of the remainder of economic activity. A variety of surveys indicate that consumer income growth is not keeping up with headline inflation (see for example the median household income and real average weekly earnings discussed in *Commentaries* No. 464 and No. 458). Where the shortfall in real income growth has been an issue for decades, debt expansion had offered an easy escape for covering the shortfall otherwise seen in maintaining living standards. In the post-2008 panic era, however, easy debt expansion has not been an option. Accordingly, irrespective of the happy numbers out of the BEA, the consumer has not had the ability to support an economic recovery.

There has been no recovery, and there is no recovery looming in the immediate future.

Among recent economic releases, the Conference Board's August consumer confidence reading continued in downturn, with confidence levels at low levels never seen historically outside of the depths of the worst post-World War II recessions. The still-to-be-published August consumer sentiment measure from the University of Michigan will be updated with the September 7th *Commentary.*



The private research sector also has been confirming the intensity of consumer liquidity problems. The Pew Research Center released a survey on August 22nd assessing the impact of real median household income declining by 4.8% from 2001 through 2010, with real household net worth declining by 28.1% during the same period. These factors have been reflected in a shrinking "middle class" and in declining standards of living.

On August 23rd, Sentier Research released a study, concluding that, "Based on new estimates derived from the monthly Current Population Survey (CPS) conducted by the U.S. Census Bureau, real median annual household income, while recovering somewhat during late 2011 and the first half of 2012, has fallen by 4.8 percent since the 'economic recovery, began in June 2009. The overall decline since June 2009 was larger than the 2.6 percent decline that occurred during the officially defined recession lasting from December 2007 to June 2009. Adding this post-recession decline to the 2.6-percent drop that occurred during the recession leaves median household income 7.2 percent below the December 2007 level."

Theses numbers generally are reflected in the regular postings here of real median household income, which are made available courtesy of www.SentierResearch.com.

Hyperinflation Watch—A Return to the Gold Standard? The Republican Platform adopted at the Tampa convention includes the following:

"Determined to crush the double-digit inflation that was part of the Carter Administration's economic legacy, President Reagan, shortly after his inauguration, established a commission to consider the feasibility of a metallic basis for U.S. currency. The commission advised against such a move. Now, three decades later, as we face the task of cleaning up the current Administration's policies, we propose a similar commission to investigate ways to set a fixed value for the dollar."

Putting aside the political rhetoric—both sides of the aisle are responsible for the financial disaster still unfolding in the United States and for the hyperinflation that looms in the not-too-distant future—this clause is being touted as a proposed return to the gold standard, where the U.S. dollar would have some form of backing in physical gold.

In principle, the idea is a good one, where it would impose monetary discipline on a system that otherwise has a demonstrated ability to operate in an extraordinarily undisciplined manner. Fed Chairman Bernanke's protestation that a gold standard limits policy options is accurate—as once noted and acted upon by President Franklin Roosevelt—but those limitations also are what force the discipline.

The problem, as noted in *Hyperinflation 2012* (page 72) is that the fiscal system needs to be in balance for the approach to work; otherwise the dollar would face continual devaluation against gold:

*"**Return to Gold Standard.*** Suggestions have been floated as to returning the U.S. dollar to full gold backing. While something like that is likely—probably a necessity—in the aftermath of the hyperinflation ahead, the problem (perhaps the desired effect) is that the gold standard would restrict the government's deficit spending. As such, in order for the new system to work, the government first would have to balance its GAAP-based spending—which I contend is not politically feasible at present. Unless fiscal circumstances are in balance, a new gold-based system would see continuous devaluations of the

dollar against gold, as unsupportable money was created. On the other hand, if fiscal conditions were in balance, returning to a gold standard likely would not be under serious consideration at present."

The important consideration here is bringing the federal budget into true balance, based on generally accepted accounting principles (GAAP), including currently unfunded liabilities for various social programs. The federal deficit on this basis is running at roughly $5 trillion per year. Anything shy of true fiscal discipline would have fleeting positive impact on the markets. Again, I do not see a balanced GAAP-based budget as a realistic possibility, and continue to look for the eventual domestic hyperinflation (outside timing of 2014).

Otherwise, general circumstances have not changed, and the text in that follows is the same as the updated text in the August 15th Commentary, except for minor reference updates. *The detail in* Special Report No. 445 *(June 12th) updated the hyperinflation outlook and the outlook for U.S. economic, U.S. dollar, and systemic-solvency conditions. That* Special Report *supplemented* Hyperinflation 2012 *(January 25th), which remains the primary* Commentary *detailing the hyperinflation story. Those reports are suggested as background reading for new subscribers.*

Official GDP reporting shows plunging economic activity from fourth-quarter 2007 to second-quarter 2009, with an ensuing upturn in activity that led to a full recovery as of fourth-quarter 2011, and that "recovery" has continued through second-quarter 2012 GDP reporting.

In contrast to GDP reporting—and in line with patterns seen in better-quality economic series—I contend that the economy began turning down in 2006, plunging in 2008 into 2009 and subsequently stagnating—bottom-bouncing—at a low level of activity, ever since. There has been no recovery since mid-2009, and the economic downturn now is intensifying once again. The renewed slowdown is evident in the current reporting of nearly all major economic series. Not one of those series shows a pattern of activity that confirms the recovery evident in the GDP series.

Federal Reserve Chairman Ben Bernanke recently observed that broad aggregate measures of the U.S. economy, such as GDP, do not appear to be reflecting the common experience of the general public. General experience suggests that the economy has not recovered. As shown in the *Opening Comments and Executive Summary*, the official recovery simply is a statistical illusion created by the government's use of understated inflation in deflating the GDP, which overstates deflated economic growth (see also *Special Report No. 445*, *Public Comment on Inflation*).

The long-term fiscal solvency issues of the United States—where GAAP-based accounting shows annual deficits running in the $5 trillion range—are not being addressed, and the politicians currently running the government lack the political will to address those issues. That circumstance initially suggested a hyperinflation crisis by the end of this decade, but federal government and Federal Reserve actions—in response to the systemic-solvency crisis of 2008—accelerated the process, indicating a hyperinflation problem by no later than the end of 2014. The continuing economic downturn is intensifying the fiscal- and systemic-solvency problems, and public awareness of this should grow rapidly in the months ahead.

Neither economic nor systemic-solvency issues have been resolved by U.S. government or Federal Reserve actions. With the economy weak enough to provide cover for further Fed accommodation to the still-struggling banking system, the next easing by the Fed—and it should follow as needed to support the banking system—likely will lead to a massive dollar-selling crisis, and that will begin the process of a rapid upturn in domestic consumer inflation. A dollar-selling crisis, however, could begin at any time, triggered by any number of economic, sovereign-solvency or political issues.

REPORTING DETAIL

GROSS DOMESTIC PRODUCT—GDP (Second-Quarter 2012, Second Estimate, First Revision)

Second-Quarter GDP Revision Matched Market Expectations But Was Little More than Statistical Noise. The second estimate of headline GDP growth for second-quarter 2012 was 1.7%, revised from an initial estimate of 1.5%, reflecting a positive contribution from new trade data, with negative offsets in lowered personal-consumption and inventory-change estimates. As usual, the data here are meaningless as indicators of underlying activity in the broad economy, with the annualized headline growth rate not statistically significant.

As usually discussed and graphed in the *Opening Comments and Executive Summary* section of the monthly GDP *Commentary*, and as detailed in *Hyperinflation 2012* and *Special Report No. 445*, the "recovery" is an illusion created by the use of understated inflation in deflating key dollar-denominated series, such as the GDP. The lower the rate of inflation that is used for the deflator, the stronger is the reported inflation-adjusted growth. Net of that inflation understatement, the revised "inflation-corrected" version of real GDP shows that economic activity has been virtually flat, at a low-level plateau activity since the economy crashed from 2006/2007 into 2009.

Consistent with this regular overstatement of broad economic activity by the Bureau of Economic Analysis (BEA), the GDP series remains the most worthless and the most heavily politicized of the government's popularly followed economic reports.

Notes on GDP-Related Nomenclature and Definitions

For purposes of clarity and the use of simplified language in the text of the GDP analysis, here are definitions of several key terms used related to GDP reporting:

Gross Domestic Product (GDP) *is the headline number and the most widely followed broad measure of U.S. economic activity. It is published quarterly by the Bureau of Economic Analysis (BEA), with two successive monthly revisions, and with an annual revision in the following July.*

Gross Domestic Income (GDI) *is the theoretical equivalent to the GDP, but it generally is not followed by the popular press. Where GDP reflects the consumption side of the economy and GDI reflects the offsetting income side. When the series estimates do not equal each other, which almost always is the case, since the series are surveyed separately, the difference is added to or subtracted from the GDI as a "statistical discrepancy." Although the BEA touts the GDP as the more accurate measure, the GDI is relatively free of the monthly political targeting the GDP goes through.*

Gross National Product (GNP) *is the broadest measure of the U.S. economy published by the BEA. Once the headline number, now it rarely is followed by the popular media. GDP is the GNP net of trade in factor income (interest and dividend payments). GNP growth usually is weaker than GDP growth for net-debtor nations. Games played with money flows between the United States and the rest of the world tend to mute that impact on the reporting of U.S. GDP growth.*

Real *(or* ***Constant Dollars****) means the data have been adjusted, or deflated, to reflect the effects of inflation.*

Nominal *(or* ***Current Dollars****) means growth or level has not been adjusted for inflation. This is the way a business normally records revenues or an individual views day-to-day income and expenses.*

GDP Implicit Price Deflator (IPD) *is the inflation measure used to convert GDP data from nominal to real. The adjusted numbers are based on "Chained 2005 Dollars," at present, where the 2005 is the base year for inflation, and "chained" refers to the methodology which gimmicks the reported numbers so much that the total of the deflated GDP sub-series misses the total of the deflated total GDP series by nearly $107 billion in "residual" as of fourth-quarter 2011.*

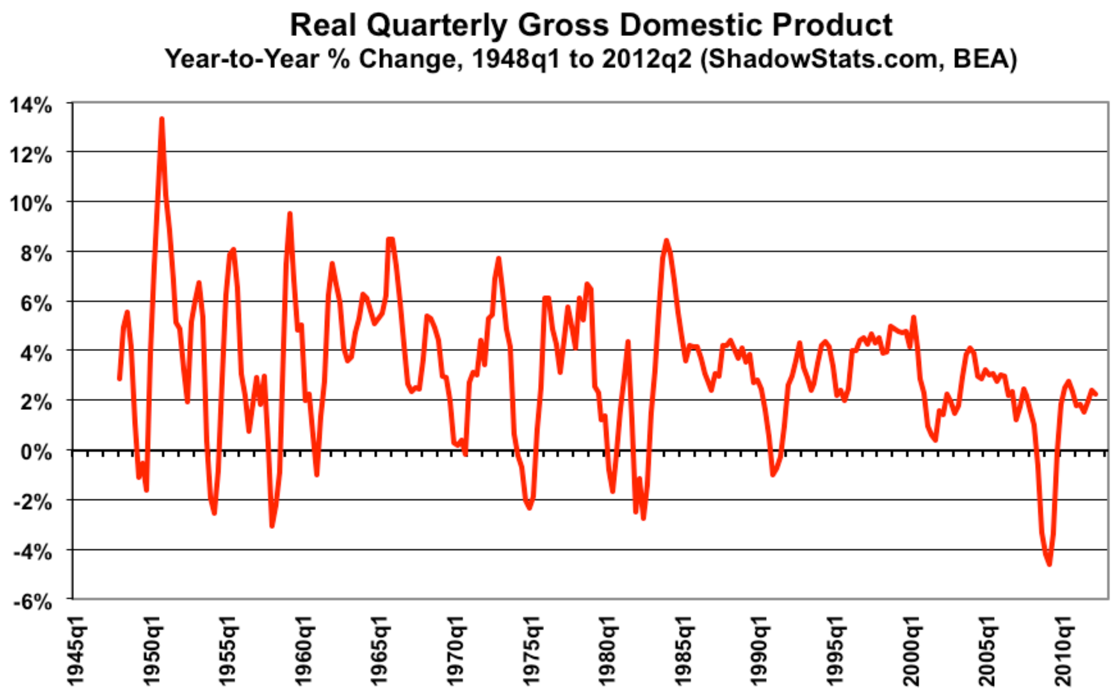
Quarterly *growth, unless otherwise stated, is in terms of seasonally-adjusted, annualized quarter-to-quarter growth, i.e., the growth rate of one quarter over the prior quarter, raised to the fourth power, a compounded annual rate of growth. While some might annualize a quarterly growth rate by multiplying it by four, the BEA uses the compounding method, raising the quarterly growth rate to the fourth power. So a one percent quarterly growth rate annualizes to 1.01 x 1.01 x 1.01 x 1.01 = 1.0406 or 4.1%, instead of 4 x 1% = 4%.*

Annual *growth refers to the year-to-year change of the referenced period versus the same period the year before.*

GDP. Published this morning, August 29th, by the Bureau of Economic Analysis (BEA), the second estimate (first revision) of second-quarter 2012 gross domestic product (GDP) showed real (inflation-adjusted) quarterly growth at a statistically-insignificant 1.73% +/- 3% (95% confidence interval), revised from an initial estimate of 1.54%. That still was weaker than the 1.96% growth reported in the first-quarter, and down from 4.10% in fourth-quarter 2011.

For five of the six quarters since first-quarter 2011 (fourth-quarter 2011 excepted), estimated growth rates have been little more than statistical noise around the unchanged level, and these heavily guessed-at numbers possibly have been massaged to keep the quarterly growth rates in minimally-positive, as opposed to minimally-negative territory.

Reflected in the next graph, the year-to-year real change in second-quarter 2012 GDP was revised to 2.26% from an initial reporting of 2.21%, down from 2.45% in first-quarter 2012. The latest annual growth still is off the near-term peak growth of 2.80% reported during third-quarter 2010. The current cycle trough was in second-quarter 2009 at a 4.58% year-to-year decline, the deepest annual contraction seen for any quarterly GDP in the history of the series, which began with first-quarter 1947.



Implicit Price Deflator (IPD) and PCE Deflator. The second-quarter 2012 GDP implicit price deflator (IPD) was revised to an annualized quarterly inflation rate of 1.58% (previously 1.51%), against 2.17% reported for the first-quarter, and 0.13% in the fourth-quarter. Second-quarter year-to-year inflation was estimated at 1.72%, little changed from the initial estimate of 1.70%, versus 1.98% in the first-quarter, and 1.96% in the fourth-quarter.

For comparison purposes, annualized seasonally-adjusted quarterly inflation for the CPI-U in the second quarter was 0.75%, versus 2.48% in the first-quarter, and versus 1.30% in the fourth-quarter, with year-to-year CPI-U at 1.89%, versus 2.82% in the first-quarter, and versus 3.29% in the fourth-quarter.

The lower the inflation rate that is used in deflating the GDP, the stronger is the resulting inflation-adjusted number and vice versa.

Year-to-year change in the second-quarter personal consumption expenditures (PCE) deflator was unrevised at 1.65%, versus 2.36% in the first quarter. The PCE deflator detail will be updated in the September 7th *Commentary*, which will cover the August 30th release of the July monthly data.

SGS-Alternate GDP. The SGS-Alternate GDP estimate for second-quarter 2012 is a 2.2% year-to-year contraction versus the official estimate of a 2.3% gain. The SGS second-quarter estimate is the same as the 2.2% contraction level estimated for first-quarter 2012, versus the official estimate of 2.4% year-to-year growth (see the Alternate Data tab).

While annualized real quarterly growth is not estimated formally on an alternate basis, a quarter-to-quarter contraction once again appears to have been a realistic possibility for the second-quarter, as it has been for five of the last six quarters, a period of protracted business bottom-bouncing in the real world.

Adjusted for gimmicked inflation and other methodological changes, the business downturn that began in 2006/2007 is ongoing; there has been no meaningful economic rebound. The inflation-corrected GDP graph (see the *Opening Comments and Executive Summary* section and *Hyperinflation 2012* and *Special Report No. 445*) is based on the removal of the impact of hedonic quality adjustments that have reduced the reporting of annual GDP inflation by roughly two-percentage points. It is not the same measure as the SGS-Alternate GDP, which reflects the impact of reversing additional methodological distortions of recent decades.

GNP. Gross national product (GNP) is the broadest measure of U.S. economic activity, where GDP is GNP net of trade in factor-income, or interest and dividend payments. Today's initial headline growth rate for second-quarter 2012 GNP was 2.21%, versus 0.61% in the first-quarter. Year-to-year growth in second-quarter GDP stood at 2.10%, versus 2.24% in the first-quarter.

The recent relative weakness or strength in U.S. GNP versus GDP reflects unusual volatility in the post-2008 crisis environment of interest and dividend payments between the rest of the world and the United States, which holds largest net-debtor status of any sovereign state in the history of the world.

GDI. Gross domestic income (GDI) is the income-side reporting equivalent of the consumption-side GDP. Today's initial headline growth rate for second-quarter 2012 GNP was 0.57% versus 3.82% in the first-quarter. Year-to-year growth was estimated at 2.13% in the second-quarter, versus 1.95% in the first-quarter.

The gyrations in GDI continue to reflect revisions to, and wild fluctuations in, estimations of personal income in the last several quarters. This will be looked at further in the September 7th *Commentary* based on availability of new monthly income estimates.

Week Ahead. *Market recognition of an intensifying double-dip recession has taken a somewhat stronger hold, at the moment, while recognition of a mounting inflation threat remains sparse. The political system would like to see the issues disappear until after the election; the media does its best to avoid publicizing unhappy economic news or to put a happy spin on the numbers; and the financial markets will do their best to avoid recognition of the problems for as long as possible, problems that have horrendous implications for the markets and for systemic stability.*

Until such time as financial-market expectations catch up fully with underlying reality, or underlying reality catches up with the markets, reporting generally will continue to show higher-than-expected inflation and weaker-than-expected economic results in the months and year ahead. Increasingly, previously unreported economic weakness should continue to show up in prior-period revisions.

Personal Consumption Expenditure (PCE) Deflator (July 2012). The Bureau of Economic Analysis is scheduled to release the July 2012 PCE deflator tomorrow, Thursday, August 30th. The Federal Reserve's targeted inflation measure (target of 2.0% year-to-year inflation) likely will come in below June's annual inflation estimate of 1.5%, paralleling the reporting patterns of the various CPI measures in

July. Nonetheless, as discussed previously, the current concept of an inflation target serves only as pabulum for the financial markets, not as a defining priority that drives Fed policy.

Construction Spending (July 2012). Due for release on Tuesday, September 4th, by the Census Bureau, July construction spending likely will show ongoing stagnation at low levels of activity, particularly after inflation-adjustment. Once again, monthly changes should not be statistically significant.

Employment and Unemployment (August 2012). August labor data are due for release by the Bureau of Labor Statistics (BLS) on Friday, September 7th. As often is the case, the consensus jobs estimate appears to be settling around the trend estimate that comes out of the BLS seasonal-adjustment models. The payroll trend number for August is for a 122,000 gain, as discussed in *Commentary No. 461*.

Nonetheless, the August numbers should disappoint market expectations, given intensifying underlying weakness in related fundamentals. Payroll growth could be well below 100,000. While the *actual* U.3 unemployment rate holding at 8.3%, or up ticking to 8.4%, is likely, the *headline* number could come in anywhere. Inconsistent concurrent-seasonal-factor adjustments make the reported month-to-month changes in the headline unemployment rate absolutely meaningless (see the unemployment concurrent-seasonal-factor discussion in the *Opening Comments* of *Commentary No. 461*).

Simply put, the headline August unemployment rate will be calculated in the context of a set of seasonal factors unique to August's reporting. That same calculation also will generate revised unemployment rates for July, and earlier, which would be consistent with the new August estimate, but the BLS will not publish the revised, consistent July number, so as "to avoid confusing data users."

As a result, that uniquely calculated August unemployment rate will be published and compared with the unrevised July unemployment rate that was uniquely calculated and published last month. The headline August and July numbers put before the public will be inconsistent and, accordingly, not comparable.

This all is despite the BLS knowing what actually is the consistent July number. If used, the consistent number could affect the headline monthly change in the unemployment rate by several tenths of a percentage point, in either direction, versus what the mainstream media will be touting, and around which the financial markets most likely will be gyrating nonsensically.

