CHAPTER 1

THE RECESSION THAT WASN'T

In all recorded history there has not been one economist who had to worry about where the next meal was coming from.

—Peter F. Drucker

It is a modern enigma. The U.S. *dollar*—the world's "reserve" currency—is weakening, shrinking, falling. It has been since the inception of the Federal Reserve, the very institution assigned with the task of maintaining its value; but it has accelerated at an alarming rate of late.

"The dollar has slumped to new lows against other currencies," has been a refrain in the financial press for several years now. From 2000 to 2004 we scribbled out our financial insights from an office in Paris. During one 18-month period beginning in late 2002 the cost of living for those expats among us—who were paid in dollars but spent money in euros—saw their cost of living go up by almost half. Still, most Americans don't ever leave the homeland, so why should we care if the dollar falls in value? Well, the answer is relatively simple. Everything—milk, eggs, gas, construction supplies, you name it—now costs more.

But what a bizarre time we live in. Economists look at the same sign and explain, "No, it doesn't cost more. They're just charging higher prices." This is what is happening in our economy, and it is happening rapidly and all around us. American economists seem to not understand it (or don't want to admit it), but we're in trouble. They need to be reminded that wet sidewalks are not the cause of rain.[1]

We have always thought of the United States as the world's leading economic engine. If by "leading" we mean buying up goods and consuming them, the United States is no longer in the lead, and that ultimately affects our entire economy and the value of the dollar. Now—and in the near future—we will see a shift away from U.S. dominance in the economy of the world, as China becomes the new global economic engine. China buys up goods from other countries, and its rate of buying is growing by leaps and bounds. Its purchases of goods from abroad surged 41 percent in 2003, passing Japan as the world's third-largest importer, behind only the United States and Germany. U.S. imports grew at the same time by just $10 billion, a mere 3 percent.

THE GREAT GDP HOAX

Economists like to talk about recoveries in terms of jobs, consumer spending, and trade with other countries. But a lot of this is just talk. What is really happening is alarming if we look at how and where we spend money. The best way to take the temperature of the economy is by measuring what we manufacture, what we spend, what we invest, and what we buy and sell. Collectively, this is referred to as the gross domestic product (GDP).

A problem, however, is that GDP is an amalgam of different things, some of which contradict one another. So looking at GDP in total doesn't tell us what is really going on. We have to look at the trends in the different pieces that make up GDP to really understand just how dire the situation has become.

You can see how difficult it is to gain anything when you look at the usual GDP formula:

GDP = Consumption + Business investment + What the government spends + Exports – Imports

When you hear that "GDP has grown in recent years," is that good news? Not necessarily; it depends on how the components of GDP have evolved. The change in GDP through 2003, for example, was skewed. While this was called a recovery, it didn't look at all like traditional recoveries we have seen in the past.

If we depend on the government to give us the information we rely on, it would be nice to get realistic information and not just answers they think we want to hear. The latest recovery isn't really a recovery at all, for example—in spite of what we are told by those in power.

The pattern of the latest recovery lacked any real momentum.

Economists also like to point out *surges*, those signs that the recovery is strong. For example, we were told that in the third quarter of 2003, GDP surged 8.2 percent—proof of a strong recovery. But it wasn't really a surge at all, only a one-time burst in consumer spending driven by tax rebates and the mortgage refinancing bubble.

While economists like momentum and surges, they hate bubbles. These are fake trends, false surges, and aberrations that don't have any momentum at all. So when we recognize that the growth in GDP was caused by an obvious bubble, it destroys the argument. Maybe GDP didn't really surge at all. Maybe it fell when we take reality into account.

We have gone through a strange period where several conditions were combined: Record-low interest rates, an exploding budget deficit, record-high consumer debt, and the housing and mortgage refinancing bubble. And at the same time (and for good reason) we experienced America's slowest economic recovery ever after a recession. This affects the value of our dollar because, in the big scheme of things, the fact that we import far more than we export—the trade deficit—is a huge problem that will ultimately destroy the U.S. dollar and its spending power. Combined with the government budget deficit, we are faced with a double-play threat to the dollar's value. The huge trade and budget deficits (known in economic circles as "current account deficit") are the real indicators we should be watching, and not the net GDP:

> Regarding the risk of a disorderly adjustment [of the U.S. trade deficit], it should be emphasized that any excessive current account deficit will need to adjust eventually. What cannot last will not last. The crucial issue is whether the adjustment will be orderly or involve a large and disruptive change in key economic variables. Such a disorderly adjustment would affect not only the rest of the world but, in particular, the deficit country itself. There are a number of factors which may increase the risk of a disorderly adjustment.[2]

In spite of the misplaced boasts to the contrary, we need to evaluate economic news from a realistic point of view. In order to judge whether something is good or bad, it needs a reasonable measure. The way American statisticians measure the economy deludes us about the extent of America's dollar problem.

The U.S. recession of 2001 was the mildest in postwar history. Normally, in a downturn in the economy people take stock of their personal balance sheets, pare back, pay off a little debt, and get their ducks in a row. Not so in 2001. In fact, Americans pulled out their credit cards and continued to spend their way right through the recession—so much so that the real work that generally takes place in a recession never happened. Debts didn't get paid off. Bad loans didn't get written off. The recession, rather than simply being the mildest in the postwar period, never really happened.

But we have kept ourselves in the dark, convinced that the economic recovery is strong because "they" have told us so. But realistically, we remain in the dark. Real GDP declined just 0.6 percent, well below the average 2 percent decline of previous postwar recessions. The great question, of course, is, what actually made this recession so mild? Quoting the chairman of the Federal Reserve, Alan Greenspan: "The mildness and brevity of the downturn are a testament to the notable improvement in the resilience and flexibility of the U.S. economy."[3]

This position—that the U.S. economy is *resilient* or *flexible*—is a widespread view among American economists. It needs drastic revision because, well, the assumption itself is absolutely false. The 2001 recession *was* unusually mild, but this positive sign was more than offset by exceptionally weak economic growth in the two years following the recession—and they don't like to talk about that.

In economics, everything is compared. We measure good and bad compared to how good or bad the averages have been. This is reasonable, or else we wouldn't know what to think about 2 percent, 8 percent, or 194 percent. In the case of the elusive and misleading (but favorite) indicator, the GDP, the decline in all postwar recessions has averaged 2 percent. But this average loss has always been followed by vigorous recoveries. On average, over the three years of recession and recovery, there is typically an average net GDP growth of 8.2 percent. Now let's compare: Over the three years 2001–2003, covering recession and recovery, real GDP grew only 5.7 percent. So any boast about a particularly mild recession, not to mention our economy's extraordinary resilience and flexibility, is an exaggeration.

This talk about the economy's resilience and flexibility is inaccurate for still another reason. Recessions were always periods of sharply slower debt growth and repayment, reflecting retrenchment in spending. The 2001 recession, in contrast, was a period when debt growth accelerated, and that is precisely what the Greenspan Fed wanted to achieve. In a speech on March 4, 2003, in Orlando, Florida, Greenspan bragged about the fact that consumers had extracted huge amounts of previously built-up equities from owner-occupied homes. For the economy, such equity extraction was financed by *debt*.

The problem has only worsened since 2001. Consumer borrowing has been growing at record annual rates. As of the end of 2004, total consumer debt ended up over $2.1 trillion, a 23 percent increase over four years.[4] (See Figure 1.1.)

Annual consumer spending and borrowing continue to rage higher at an annual rate of $480.3 billion. Even so, Greenspan has pointed to consumer trends as positive indicators. That strengthening trend, however, has come from inflating stock and house prices. Debt is soaring, and *that* is the problem. It would be different if that spending was going into a savings and retirement account or, in the case of business, into factory machinery. But it is not. The GDP growth involves spending money *and* borrowing the money rather than using earnings. That's where the problems lie, and that's where

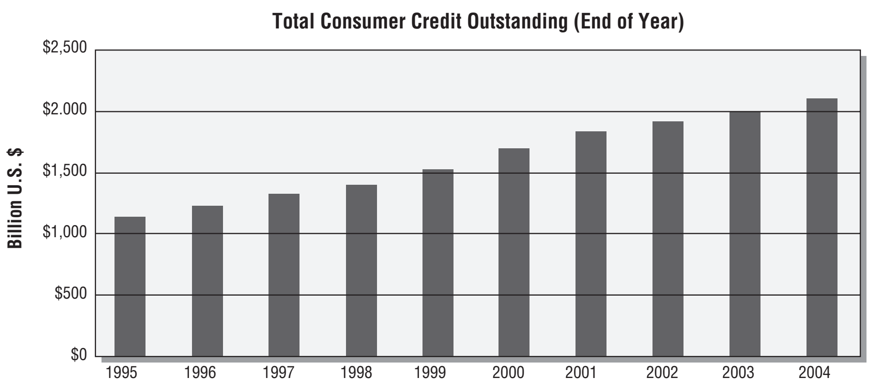

FIGURE 1.1 Consumer Credit Outstanding, 1995–2004
(*Source:* Federal Reserve.)

the demise of the dollar is going to occur. At some point in the near future, our country is simply going to run out of credit. We're going to max out our monetary credit card.

It is the debt itself, out of control and getting worse, that is going to cause the loss of the dollar's spending power. The higher our consumer debt and our government debt, the weaker the dollar becomes. And that means your savings and retirement account and your Social Security check are going to be worth less and less. This currency crisis is augmented by the fact that China is taking over in the world economy: it is becoming the leading importer, manufacturer, and producer in the world.

TIGHTENING THE BELT

Before the demise of the dollar can be arrested, the causes—runaway debt and U.S. government policy—must be addressed. As a personal investor there's not much you can do but understand the trends in place and position your portfolio for success. You need to understand *why* prior structural flaws have gotten us to this point. Several things have contributed to this problem, including not only excess credit, but also the lack of savings and investment among American consumers.

A recession is a retreat, a decline in GDP, employment, and trade. Not surprisingly, most people think of such economic forces in terms of lost jobs, which is only one aspect of the bigger picture. But just as recession has an expanded meaning, so does recovery.

In the past, U.S. recessions resulted from tight money and credit. This translates to difficulty in getting loans (especially for homeowners and small businesses). It used to be a symptom of recession that people would say, "Money is tight."

We rarely hear that anymore. Why? Because money isn't ever tight these days; it's just worth less and less. The old-style recession and its accompanying tight money forced consumers and businesses to cut back on borrowing and spending excesses—belt tightening. This change in behavior eventually brought the economy and the financial system back into balance. Cutting back on credit when recession occurs is a form of "economic dieting." We have to slim down to get away from tight money, so that the economy can get back into those tight jeans it wore last summer. Most of us know exactly what that is like, and what it means.

Something has changed in the United States. Our economy is fast becoming morbidly obese and we have long abandoned the desire to slim down. We just keep buying bigger and bigger expectations. We've been living in the bubble.

It has become official economic policy, under Alan Greenspan's tenure with the Fed, to not only accept but to actually *encourage* borrowing and spending excesses. This occurs under the respectable label of "wealth-driven" spending.

When we speak at conferences and talk to people around the country we're consistently surprised at how little people actually know about the money they pack away in their wallets. Since 1913, and the passage of the Federal Reserve Act, the federal government has ceded the power over money expressly given to it by the Constitution to private interests. Article I of our Constitution gives *Congress* the power to coin money and to regulate its value. But that power has been delegated to the Fed, which is essentially a banking cartel and *not* part of Congress. This isn't just politics or stuffy economics. By allowing the Fed to have this power, we have no direct voice in how monetary policy is set, not that it would do much good anyway. The loss of sound money—money backed by a tangible asset, rather than a government process—is the root imbalance that's plaguing the dollar.

To give you an idea of how the recession and recovery trend has changed, look at the historical numbers—the *real* numbers and not the political/economic numbers we are being fed. (See Table 1.1.)

TABLE 1.1 PERCENTAGE CHANGES IN KEY ECONOMIC AGGREGATES DURING RECESSIONS AND RECOVERIES

Peak-to-Trough Percentage Changes in Key Economic Aggregates during Recessions

	Average of Six Recessions	1990–II to 1991–I	2000–III to 2001–III
Real GDP	–2.0	–2.0	0.2
Personal consumption	0.7	–1.1	1.8
Producer equipment	–10.8	–4.3	–8.2
Nonresidential structures	–4.2	–7.4	–2.12
Residential investment	–10.7	–18.7	2.4
Industrial production	8.2	–2.8	–4.1
Private employment	–2.7	–1.1	–0.1
Real disposable income	0.1	1.0	2.8
Real wage and salary income	–2.0	–2.5	1.9

Percentage Changes in Economic Aggregates during First Eight Quarters of Recovery

	Average of Five Recoveries	1991–I to 1993–I	2001–III to 2003–III
Real GDP	10.2	4.2	2.8
Personal consumption	9.9	4.4	6.1
Producer equipment	21.4	18.6	7.9
Nonresidential structures	4.8	–13.7	–3.6
Residential investment	36.7	23.7	15.9
Industrial production	17.9	6.2	1.6
Private employment	6.6	0.5	–1.3
Real disposable income	9.0	4.4	6.1
Real wage and salary income	9.0	1.9	4.3

Source: Richebächer Letter, December 2003.

The peak-to-trough changes shown in past recessions make the point: We're not gaining and losing economic weight and returning to previous health in the same way; something has changed drastically and, like a Florida sinkhole, we're slowly going under.

That's why the dollar crisis is invisible. We really don't want to think about it, and the Fed enables us to ignore it by telling us that all is well. As long as credit card companies keep giving us more cards and increasing our credit limits, why worry? And that, in a nutshell, defines the economic problem behind the demise.

An economist would shrug off these changes as cyclical or simply as signs that in the latest recovery a bias toward consumption is affecting outcome. But what does that mean? If, in fact, we are no longer willing to accept tight money as a reality in the down part of the economic cycle, how can we sustain economic growth? How much is going to be enough? And what will happen when seemingly infinite credit and debt excesses finally catch up with us?