# CHAPTER 1

# THE "RECOVERY" 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 the decline 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. In 2007, it will still cost you about 50 percent more to live or travel in Western Europe. The day before Thanksgiving 2007, the dollar fell to $1.4856 per euro—its weakest rate of exchange since the euro debuted in 1999—but it's worse for *Daily Reckoning* colleagues who work or travel in London. My colleague, Bill Bonner, spent $425 for a modest night out that included a few tickets to a West End play (the Brit equivalent of Off-Broadway), a cab ride, and dinner at a Chinese restaurant.

Still, most Americans don't ever leave the homeland, so why should we care if the dollar continues to fall in value? Well, the answer is relatively simple. Everything—milk, eggs, gas, construction supplies, you name it—now costs more—a lot more. When the Federal Reserve talks about inflation, it likes to make a distinction between overall inflation and core inflation, which excludes energy and food prices (exactly the day-to-day costs that worry most consumers).

The average price for a gallon of unleaded regular gasoline more than doubled from January 2000 to July 2006, jumping 130.5 percent, according to the U.S. Bureau of Labor Statistics, and that doesn't count the increases we've seen in 2007 that have pushed the price to $3 and more a gallon.

Inflation is even worse in grocery aisles. According to the Food Marketing Institute (FMI), the average household spends $92.50 a week on groceries—move if they have kids. In the first *six months* of 2007, grocery prices rose 7.5 percent—almost three times all of 2006's 2.1 percent increase in prices. That's the biggest annual percentage hike since 1980, according to the U.S. Department of Labor. By the time 2007 ended, food costs had swelled 5.6 percent—more than double all of 2006. Even the price of heavily regulated milk has seen a hefty jump, rising from $3 in 2001 to $3.55—and closer to $4 in some markets—by October 2007. And the upward spike continues in 2008. The U.S. Department of Agriculture is forecasting an increase of 3 to 4 percent this year.

Three dollars for a gallon of gas, mixed with falling house values—it's a double whammy for consumers. And how are they reacting? The FMI reports that meat is the most shoplifted grocery item since 2005, and as winter 2007 arrives, food pantries across the country report dwindling supplies.

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." But this is what is happening in our economy, and it is happening rapidly and all around us. Most American economists seem to not understand it (or don't want to admit it), but we're in trouble. Some economists may be finally catching up with consumers. Or maybe not. They can't seem to make up their minds. But this is the second year we've been hearing the "R" word.

In October and November 2007, the National Association for Business Economics reported that half of those economists surveyed see a recession on the horizon. But they, like the Fed, are an ever-optimistic lot: They look at the weak increase in the GDP of 2.6 percent projected from now to the fourth quarter of 2008, and pronounce it good because it is slightly ahead of 2007's anemic 2.4 percent.

Then, in November, the Fed slashed its 2008 forecasts to 1.6 to 2.5 percent, a big drop from 2.5 to 3 percent forecast earlier. Words like "subpar economic growth" and "below trend" expectations lasting into 2009 tell us what's really going on: We're headed for deep water.

We have always thought of the United States as the world's leading economic engine. If we mean this in terms of 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.

In 2006, China's purchases of goods from abroad surged 20 percent, putting it well ahead of Japan (13 percent), the United States (11 percent), and Germany (7.32 percent). Percentages don't have the impact of dollar and yen figures, so chew on this: Midway through 2007, in May, China's trade surplus with the world widened to nearly $22.5 billion, according to U.S. Customs. That's almost $6 billion more than in April and only about a billion shy of the record. Year over year, China's exports were up 73 percent from May 2006.

These numbers are ironic, given the amount of time Treasury Secretary Henry Paulson spent with the Chinese in trade talks recently. Paulson can try to talk up the U.S. economy all he wants, but the Chinese, the numbers reflect, would rather make stuff . . . and sell it. Elsewhere in the global financial expanse, Asian markets are seeing some of their best performances in history:

- In Mumbai, the BSE Sensex topped 15,000 for the first time.
- In Tokyo, the Nikkei 225 notched a seven-year high.
- Hong Kong's market closed at a record for the fifth straight day.

- Seoul has had four consecutive record-setting days.
- In Sydney, the Aussie market marked its 34th record close this year.

Translation: Chug, chug . . . our economic engine is falling behind, weighed down by debt and too many imports.

## 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 are interpreted.

The change in GDP through 2003, the most recent recession when *The Demise of the Dollar* was originally published in 2005, was skewed. While economists referred to the GDP's 2003 performance as a recovery, it didn't look at all like traditional recoveries we have seen in the past. And now we're being handed the same spin about the downturn in 2006 and the recession predicted for 2008 and beyond. We're even hearing the same rhetoric about the stimulus package. It's all similar to the talk we heard during the last recession in 2001.

In the third quarter of 2007, for example, Fed Chairman Bernanke assures us that the GDP is strong at 3.9 percent, a repeat of the second quarter's growth of 3.8 percent. But in looking at the numbers from the Bureau of Labor Statistics and at the words, in big bold letters, "GDP Grows 3.9 Percent in Third Quarter" (see the October 31, 2007, press release), it is always helpful to note the information found in the second line, in much smaller type: "Advance" estimate. The Bureau of Labor Statistics has revised the GDP down every year since 2002. A big source of real GDP growth in the third quarter of 2007 was personal consumption, which doubled from 1.4 percent in the second quarter to 3 percent. Meanwhile, housing values fell and imports grew. Does this add up to a strong GDP, in your opinion?

So far this year, inflation has risen 3.6 percent—a full percentage point above inflation in all of 2006 of 2.5 percent. That says a lot about reliable government numbers. 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—in spite of what we are told by those in power.

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.

In 2003 (and for good reason), we experienced the country's slowest economic recovery ever after a recession, and it doesn't look any better in 2007. 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 mess in the credit markets, which created the mortgage meltdown that has led to the decline in housing values. 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 the current account deficit) are the real indicators we should be watching, not the net GDP.

In April 2007, the U.S. trade deficit was more than twice as big as China's surplus—$58.5 billion. That says a lot about the state of our economy. We even set a record: From 2001 to 2006, we more than doubled our deficit, from $365 billion to now $763 billion.

To make matters worse, in September, Congress raised the ceiling on debt by $850 billion, to $9.815 trillion, to accommodate our growing girth. Yes, I said *trillion.* We came close to overreaching the $9 trillion mark ($8.993 trillion) in 2007, which is why Congress had to raise the ceiling. That's the third time since the end of fiscal year 2003 that Congress has taken this action, but that doesn't seem to bother anyone else but me and David Walker, former head of the GAO, now president and CEO of the newly founded Peter G. Peterson Foundation. Walker, who has been auditing the federal debt since 1997, noted these startling facts in the letter prefacing the most recent audit:

> We have audited the Schedule of Federal Debt since fiscal year 1997. Over this period, total federal debt has increased by 73 percent. During the last 4 fiscal years, managing the federal debt has continued to be a challenge as evidenced by the growth of total federal debt by $2,210 billion, or 33 percent, from $6,793 billion as of September 30, 2003, to $8,993 billion as of September 30, 2007.[1]

True, the budget deficit has slowed down in each of the past three years, from $248 billion in 2006 to $163 billion in 2007. But that's still a heck of a lot of money, and it's not the worst of the problem, says Walker:

> . . . our nation's real challenge is not short-term deficits, rather it's the U.S. government's impending longer-term structural deficits and related debt burdens. Indeed, what we call the longer-term fiscal challenge is not in the distant future. The first of the baby boomers became eligible for early retirement under Social Security on January 1, 2008 . . . and for Medicare benefits just 3 years later. . . .

> GAO's long-range fiscal policy simulations show that the nation's current fiscal condition is but a prelude to a much more daunting long-term fiscal challenge.[2]

Is anyone listening to this guy? If you want to read more, see "Our Nation's Fiscal Outlook: The Federal Government's Long-Term Budget Imbalance," available at www.gao.gov/special.pubs/longterm.[3]

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.

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, 2006, and, if the history of our habits proves true, in 2008. Americans pull out their credit cards and continue to spend their way right through a recession—so much so that the real work that generally takes place in a recession never happens. Debts don't get paid off. Bad loans don't get written off. The recession never really happened—that's what we believe.

But we have kept ourselves in the dark, convinced that the economic recovery is strong because "they" have told us so. Realistically, we remain in the dark. Real GDP declined just 0.6 percent in 2001, 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 then 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."[4]

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 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 Greenspan wanted to achieve. It's eerie now to think back to a speech, on March 4, 2003, in Orlando, Florida, when he 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.[5] When consumer debt reached that amount, it doubled the load shouldered only 10 years before, in 1994, and seemed to set a new record. But in the third quarter of 2007, consumer debt swelled to $2.5 trillion—a 25 percent increase in less than three years. (See Figure 1.1.)

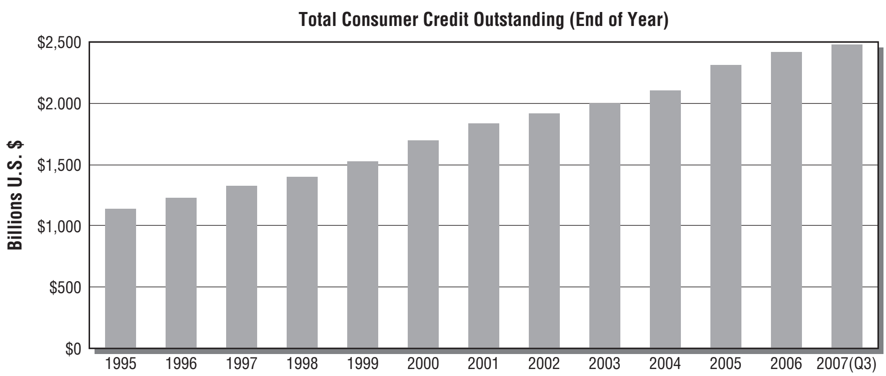


**FIGURE 1.1** Consumer Credit Outstanding, 1995–2007
(*Source:* Federal Reserve.)

Annual consumer spending and borrowing continue to rage higher at an annual rate of $480.3 billion. Consumer spending is seen as a positive indicator. 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 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 as a result of 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 became official economic policy under Alan Greenspan's tenure with the Fed not only to accept but to actually *encourage* borrowing and spending excesses. This occurs under the respectable label of "wealth-driven" spending. While he doesn't seem to have the same chronic condition of "interestitis" that afflicted his predecessor, Bernanke has pushed forward four steady rate cuts this year, in August, September, October, and December.

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. Early in 2007, President George W. Bush released a budget in which the ledger shifts from red to black and shows a nice surplus, of $61 billion, by 2012. But—and this is a big *but*—it assumes real government spending growth of 0.4 percent a year. Bush has been racking up real growth at the rate of 4.6 percent since he took office in 2001, compared with 2.7 percent under Ronald Reagan and 0.8 percent under Bill Clinton. As the Federal Reserve Bank of Dallas wrote in April 2007, "Washington's fiscal fitness remains a matter of concern. . . . The most recent proposal envisions eliminating them [budget deficits] within six years, but doing so will require lawmakers to overcome several significant obstacles."[6]

And we all know, unfortunately, that's not likely to happen, given the fiscal leadership we've seen so far.

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?