ALL THAT MONEY CAN'T BUY:
Understanding Inflation – Despite "Ignorance By Design"

Despite its effect on our lives, inflation is poorly understood by the general public. Beyond its broadest-brush definition as a rise in general prices over time – coupled with the prevailing generalized sentiment that this is "bad" - few Americans outside of the economic and investment communities have any considerable appreciation for inflation's causes or effects, let alone the mechanisms used for its measurement. As a consequence, few are in a position to understand how economic data stands to be manipulated for popular consumption, or what ends this manipulation may serve.

The dictionary defines inflation as "a persistent, substantial rise in the general level of prices related to an increase in the volume of money and resulting in the loss of value of currency." As this definition extends beyond the laymen's simple understanding of higher prices at the supermarket checkout line or at the gas pump, it is certainly more useful when it comes to comprehending the current gyrations in financial markets or the precipitous decline in the value of the dollar versus other global currencies. Even so, this definition only hints at a description of a broad, far-reaching phenomenon whose material consequences at the international, national, local, and individual levels stand to be immense in scope over the coming years.

Some of the confusion surrounding inflation stems from the federal government's own approach to the subject. In recent decades, officials – primarily those in the Bureau of Labor Statistics – have taken to modifying the definitions, methodologies, and metrics used to measure and describe inflation, explaining their actions as efforts to attain a higher degree of accuracy with regard to results and forecasts. A pessimist's assessment of these activities would, on the other hand, hold that they were undertaken for nakedly political ends: By "changing the yardstick" through which inflationary data is measured and changing the terminology through which it is explained, officials are able to obfuscate less-than-palatable information, conceal poor performance, and restrain consequent impulses towards negative corrections within financial markets.

A public with a minimal grasp upon the concept of inflation itself is in a poor position when it comes to apprehending the nature and the scope of such changes, or in appreciating their sweeping consequences. Two such changes within the past two decades are particularly worthy of note:

- Beginning in 1997, the Bureau of Labor Statisics chose to omit both fuel and food prices from its Core Consumer Price Index surveys;
- In 2006, Federal Reserve ceased reporting M3 aggregate figures concerned with currency supply, specifically with regard to the rate at which U.S. currency was being printed and distributed.

The immediate and obvious consequence of both these changes is that it becomes much more difficult to formulate a highly accurate assessment of inflation and inflationary trends at any given point in time—particularly in regard to gauging the actual "cost of living" impact upon consumers. As a result, meaningful working, day-to-day projections become that much more difficult to formulate, particularly for non-specialists. In practice, a public benefit of such obfuscation is a mitigation of impulses towards market (or popular) panic; a private benefit, reserved for those charged with shepherding U.S. fiscal and economic policy, is that it is more difficult to trace their actions or lack thereof to a measurable economic consequence.

This is not to say that such consequences do not exist, as anyone who has taken note of $1000 gold or $110 oil in recent weeks can attest to. Some of those who have taken note—and with considerable alarm—have created a virtual cottage industry of tracking the data that the Federal Reserve and the Bureau of Labor Statistics have abandoned, and providing their prognostications to similarly-worried audiences of website visitors and newsletter subscribers. One such firm, John Williams' Shadowstats.com, makes it its practice to measure consumer prices and inflation by their traditional, historic indices rather than by the government's recently adjusted metrics. Shadowstats.com maintains its own M3 money supply calculations, and factors energy and food into its inflation figures. The resulting figures are, at least at first glance, sufficient to cause even the most seasoned investors some degree of alarm.

Shadowstats.com's M3 figures indicate a current rate of increase in the money supply of nearly 18% annually - more than double the 8% official rate in effect in 2006, at the time official M3 reporting ceased. (1) Likewise, Shadowstats' current inflation figures for 2008 show a rate of nearly 12%, as opposed to the approximate 4% official figure. (1) If the site's figures are indeed correct, it is no wonder the economy's stewards at the Federal Reserve would be disinclined to continue reporting results based upon traditional metrics.

Unfortunately, the bad statistical news doesn't stop there. The site also projects first-quarter 2008 GDP growth rate, as measured by traditional rather than current methods, of negative two percent, and unemployment estimates substantively higher than official figures (the site continues to count "discouraged workers" who have been unemployed for over six months, a group who have been omitted from the official government statistics since the Clinton administration). (1) It seems reasonable to assume the diminished demand for commodities and goods suggested by both a high unemployment rate and a sluggish GDP are in fact acting as mitigating factors on inflation, and that inflation rates would be higher still otherwise.

Other experts hold a divergent range of opinions in regard to inflation's actual rates and true causes. Some increasingly cite the European and U.S. push towards biofuels as a driver behind skyrocketing agricultural commodity prices. (2) Others emphasize increased third-world demand for commodities, or commodity speculation triggered by anemic interest rates (3) in addition to the growth in the money supply. The nearly universal belief seems to be, however, that inflation stands to pose significant challenges in an already troubled U.S. economy, and that overly-rosy government assessments will do little to help in meeting the challenges this outlook poses.

In the area preceding the dot-com bubble, and even in the big-borrowing housing bubble years that followed, many Americans could afford to ignore inflation and the quiet machinations surrounding it. As price rises start to be felt in Americans' pocketbooks, however, this stands to change: U.S. Consumer Price Index data released in January, 2008 indicated an overall food cost increase of 4.9%, with the price of groceries themselves increasing 5.6%, during 2007. What seems certain is that in an era marked by rising prices, a highly competitive job market, a collapsing dollar, and a badly-wounded real estate market, ignorance becomes perilous. What we don't know *can* hurt us—and already has.

(1) Shadowstats, http://www.shadowstats.com/alternate_data
(2) Loch Adamson, "Fueling Opportunity," *Alpha Magazine,* February 2008.
(3)James D. Hamilton and Menzie Chinn, Econbrowser, http://www.econbrowser.com/archives/2008/03/would_you_like.html#more