John Williams'

Shadow Government Statistics

Analysis Behind and Beyond Government Economic Reporting

Flash Update No. 17

War Would Intensify Current Negative Financial Market Stresses

January 6, 2020

**War Risks Can Shift Underlying Financial and Economic Resources,
Some to the Downside, Some to the Plus Side**

**Current Extremes of Fiscal and FOMC Imbalances and Policies
Threaten Massive Systemic Instabilities, Ranging from the
Economy and Financial Markets, to Domestic Inflation**

**Last Time the Federal Debt-to-GDP Ratio Topped 70%, Let Alone the
Currently Unsustainable 107%, Was in 1944/1945, at the End of World War II;
What Happens Now if the U.S. Goes to War?**

**FOMC Banking-System Mismanagement and Bailout, and Coincident
Federal and Corporate Policies Aimed at Shifting Domestic Production Offshore
Have Weakened Potential Domestic Manufacturing of Defense Goods**

**At the Same Time, War-Time Production Needs Would Tend to
Reactivate Some Key Manufacturing in the United States**

**Congress, the Executive Branch and the Federal Reserve All Are Culpable, in
Pursuing Short-Sighted and Negligent Domestic Economic Policies**

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Risks Mount of a Major New Conventional War in the Middle East

Mid-East Military Tensions Escalated Sharply, Late January 2nd, After a U.S. Airstrike in Iraq Targeted and Killed Iranian General Soleimani. From the U.S. Department of Defense statement:

> At the direction of the President, the U.S. military has taken decisive defensive action to protect U.S. personnel abroad by killing Qasem Soleimani, the head of the Iranian Revolutionary Guard Corps-Quds Force, a U.S.-designated Foreign Terrorist Organization.
>
> General Soleimani was actively developing plans to attack American diplomats and service members in Iraq and throughout the region. General Soleimani and his Quds Force were responsible for the deaths of hundreds of Americans and coalition service members and wounding of thousands more. ...

The rhetoric and threats still are escalating at a pace that could lead to expanded military action and open conflict. In response to the unfolding circumstances, Gold and Oil prices soared on Friday and held most of their gains today, January 6th.

Major Conventional War Would Have Meaningful Impact on the Economy and Financial Markets in the Year Ahead. While one certainly may hope there will be no major war—I do not think there will be one—its potential still has to be considered in economic and financial forecasts of the year ahead. I had planned to publish ***Special Bullet Edition No. 19***, today, on more standard economic and financial-market developments for the year ahead. That has been bumped to a likely January 8th posting, while this ***Flash Update No. 17*** considers a couple of financial and economic conditions tied to a potential war, in the context of current economic and financial-system circumstances. Those are against similar activity seen since 1929, the first year of Gross National Product (later Gross Domestic Product) reporting. A common thread to areas examined shows that the Federal Reserve's ineffective 2008 bailout of the then-failed banking system underlies certain economic and financial-system constraints on what otherwise should be a fully defensive United States.

Best wishes to all – always happy to talk any time.

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Ratio of Nominal Gross Federal Debt to GDP Is at Levels Last Seen in World War II

Current Surge Coincided With the Banking System Bailout and Excessive Deficit Spending

Where Do the Debt Ratio and Global Perceptions of U.S. Solvency Go in the Event of War?

Wars Tend to Bloat National Deficits. When a nation goes to war, beyond defenses built and armaments inventoried during peacetime, needed armaments and troops cost money that usually get paid for by national debt expansion. Consider the United States and its economy, reflected in ***Graphs 1*** and ***2***. ***Graph 1*** is similar to previously published graphs of the fiscal-year nominal GDP versus the fiscal-year level of the nominal Gross Federal Debt, except it is extended back to the initial annual reporting of Gross National Product (GNP) in 1929, later replaced back to 1920, with the narrower Gross Domestic Product (GDP), which excluded the trade balance from Factor Income (Interest and Dividend Payments).

Allowing for the differences between shifting fiscal-year patterns, and simple average-year numbers, the plots remain effectively indistinguishable from what they would have been otherwise.

Graph 1 shows the level of nominal Gross Federal Debt exploding against GDP at the beginning of the last decade, in a manner not seen since World War II, as reflected best in ***Graph 2***. The ratio of Gross National Debt to Gross Domestic Product first broke above 70% in 1943, peaking at 119% in 1946, before de-escalating down to 32% in 1972. In the present circumstance, increased annual deficit spending broke above 70% in 2009 to 83%, from 68% in 2008, in the wake of the Banking System collapse, and the Fed's Banking System bailout, with explosive deficit spending, rising up to 107% in 2019, levels based on a mismanaged economy and banking system, yet at the World War II crisis levels.

What would happen here in the event of a major, conventional war, likely would push global currency-market challenges to U.S. solvency to levels well beyond anything ever seen before in U.S. history. Global market reaction would tend to trigger flight from the U.S. dollar to any stronger currency, and most certainly to physical gold and silver.

The U.S. Dollar underlies the U.S. financial system and still, to a dominant extent, the global financial system. These areas all are at increasing risk in a major, financially draining war, involving an otherwise insolvent United States.

[Graphs 1 and 2 follow on the next page.]

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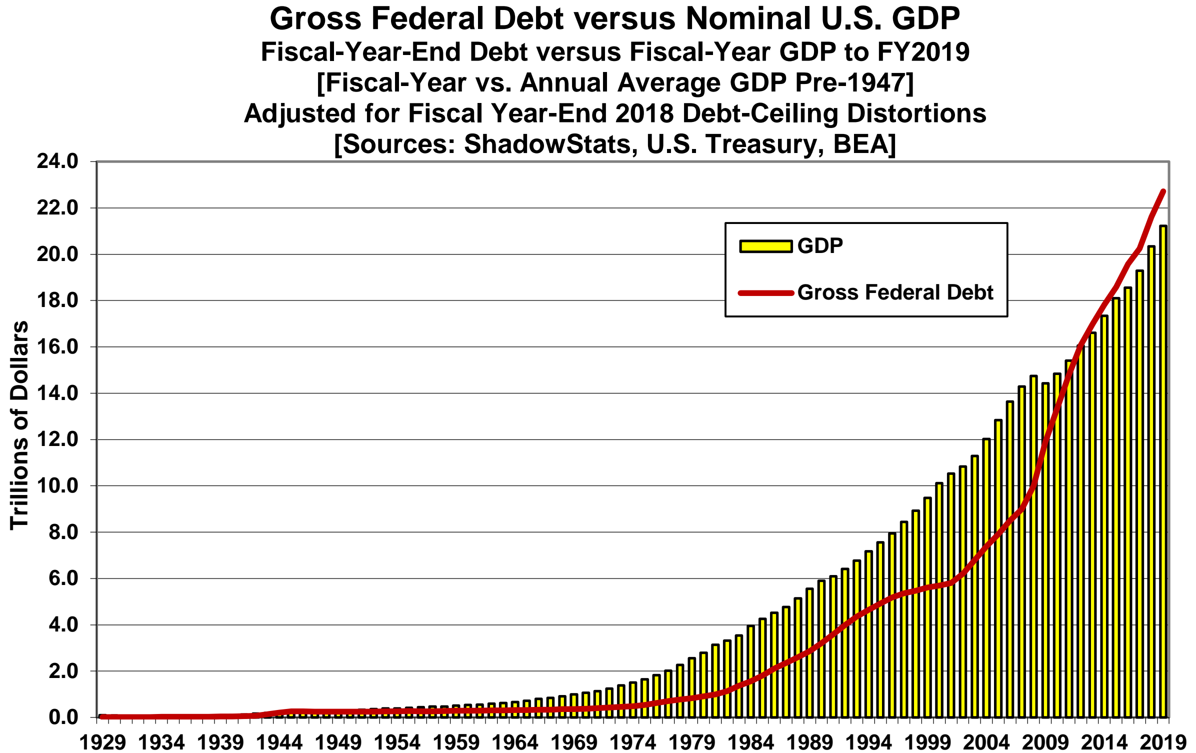
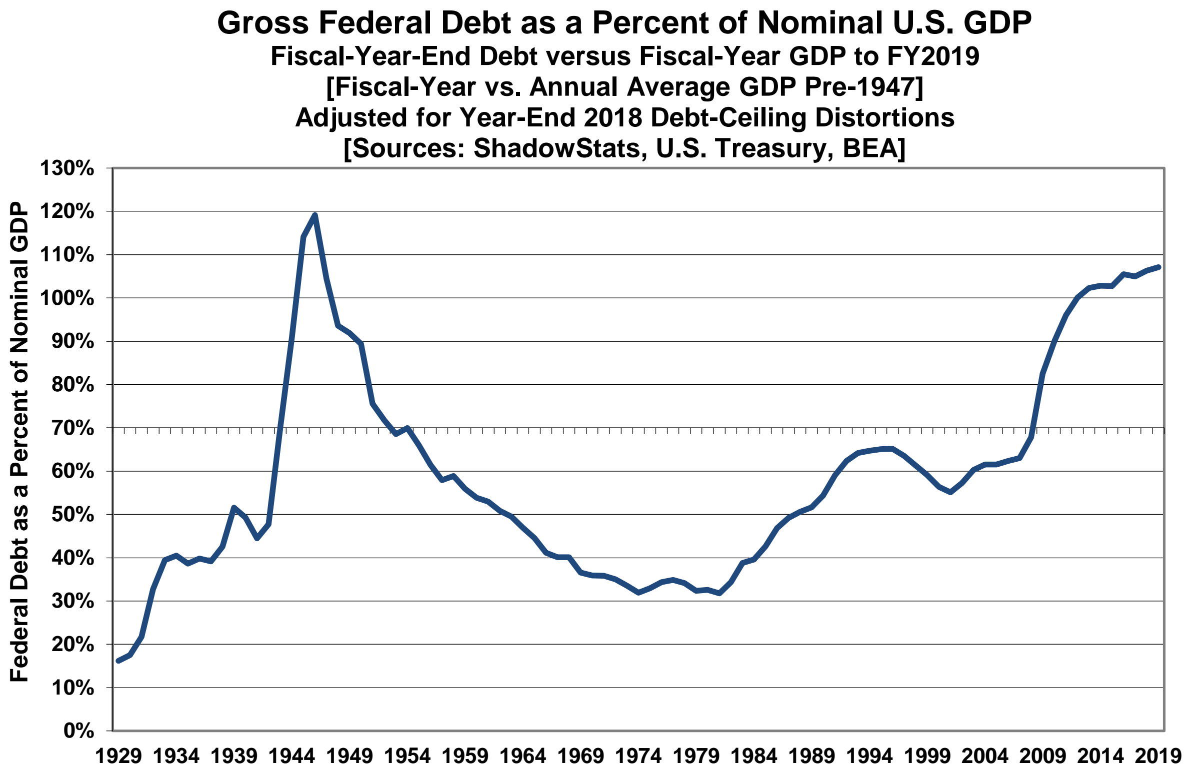
Graph 1: Nominal Gross U.S. Federal Debt versus GDP (1929 to Date)



Graph 2: Nominal Gross U.S. Federal Debt as a Percent of GDP (1929 to date)



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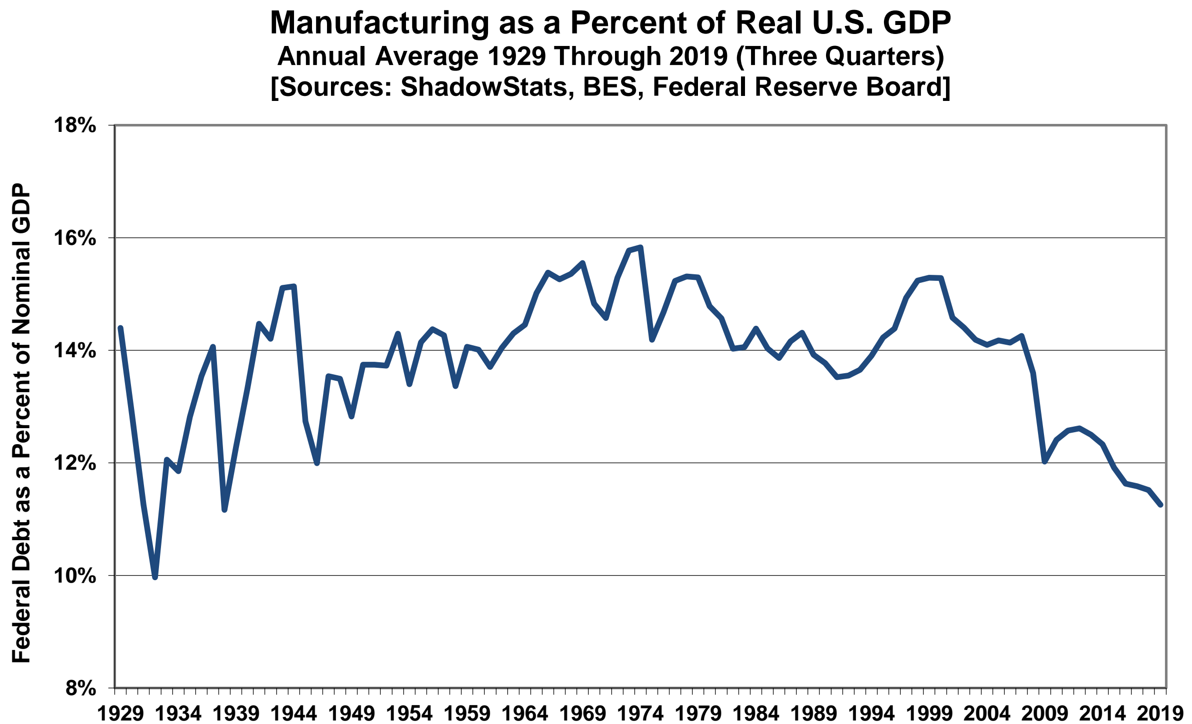
Practical Economics: the U.S. Needs to Be Able to Produce Weapons and Materials to Conduct an Extended War, Yet Current Manufacturing Has Dropped to Its Lowest Percent of GDP Since 1938. Reflecting ever expanding U.S. trade deficits and deals that have transferred U.S. production and technology offshore, U.S. manufacturing in 2019 was at its lowest level versus GDP since 1939, three years before Pearl Harbor (see ***Graph 3***).

The declining U.S. manufacturing base reflects concerted efforts to shift domestic production to cheaper manufacturing offshore. That circumstance was exacerbated at time of the banking system collapse and 2008 Federal Reserve bailout of the Banking System, reflected in the late-term 2009 trough in ***Graph 3*.**

Considering the nature of products and magnitude of shortfall, China should be a concern, where they likely would not be an ally in the unfolding Middle-East Crisis. China accounted for 62% of the total nominal U.S. calendar 2018 Trade Deficit in Goods and Services.

In the event of war, this analysis will be expanded significantly. Pending ***Special Bullet Edition No. 19*** will look at more-standard economic conditions in the year ahead, assuming no expanded war, although standard conditions ahead are well shy of the buoyant consensus outlook (***Special Commentary No. 985***).

Graph 3: Nominal Gross U.S. Federal Debt as a Percent of GDP (1929 to date)



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