John Williams'

Shadow Government Statistics

Analysis Behind and Beyond Government Economic Reporting

SPECIAL COMMENTARY NUMBER 323
Updated Outlook on Economy, Systemic Stability and Financial Markets

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Protracted Economic Downturn Re-Intensifies

Systemic Stability: "Tap-Dancing on a Land Mine"

Risks of U.S. Dollar Instability and Systemic-Salvation Efforts
Pose Severe Inflation Threat

PLEASE NOTE: This Special Commentary *is intended to provide a brief summary and update of the extraordinary economic and systemic conditions that have dominated public, political and central bank concerns of the last three years and that continue to unfold in a manner that promises even greater difficulties ahead. The general outlook is unchanged.*

The week ahead will see a regular Commentary *tomorrow, Tuesday, September 14th, following release of August retail sales data. A* Commentary *also will be published on Friday, September 17th, following the release of the August CPI, with detail also on the August PPI and industrial production, as well as the 2010 Poverty Report (2009 data), which is due for release on Thursday, September 16th.*

-- Best wishes to all, John Williams

SUMMARY OUTLOOK

Systemic Turmoil is Unthinkable, Unacceptable but Unavoidable. Pardon the use of the Aerosmith lyrics in the opening headers, but the image of tap-dancing on a land mine pretty much describes what the Federal Reserve and the U.S. Government have been doing in order to prevent a systemic collapse in the last couple of years. Now, as business activity sinks anew, much expanded supportive measures will be needed to maintain short-term systemic stability. Such official actions, however, in combination with global perceptions of limited U.S. fiscal flexibility, likely will trigger massive flight from the U.S. dollar and force the Federal Reserve into heavy monetization of otherwise unwanted U.S. Treasury debt. When that land mine explodes -- probably within the next six-to-nine months, the onset of a U.S. hyperinflation will be in place, with severe economic, social and political consequences that will follow. The *Hyperinflation Special Report* is referenced for broad background. The general outlook is not changed.

U.S. Economy. Already the longest and deepest economic contraction of the post-World War II era, the current downturn in the U.S. economy is re-intensifying, with no near-term stability or recovery on the forecast horizon. After an initial plunge, broad-based business activity bottom-bounced at a low-level plateau for more than year. Shy of short-lived bumps in activity from stimulus measures, there has been no recovery. Reflecting an intense real (inflation-adjusted) annual contraction in broad systemic liquidity (SGS-Ongoing M3 estimate), the economy has started to contract anew. In the popular media, where the hype of a recovery-at-hand readily was accepted, the renewed downturn already is being called a "double-dip," but underlying reality is that of an extremely protracted, deep and ongoing contraction. If there is a double-dip, it is in the combination of the two major economic downturns of the last decade (see graphs).

Structural problems tied to lack of real consumer income growth -- and worsened now by a credit-intensified contraction in consumer liquidity -- pushed the economy into recession by early 2007, almost a year before the officially-clocked onset of December 2007. Such helped to trigger the credit collapse, which exacerbated the unfolding downtown and threatened systemic collapse. Despite extraordinary efforts to prevent a failure of the banking system, the structural consumer liquidity issues have not been addressed. Until they are, sustainable growth in U.S. business activity will be lacking.

The current contraction likely will meet my definition of depression (a greater than 10% real decline in peak-to-trough activity). In response to a likely hyperinflation, the current circumstance would evolve into a great depression (a greater than 25% real decline in peak-to-trough activity). Ongoing contractions in the world's largest economy have sharply negative implications for global economic growth, but the hyperinflation risk for the United States likely will not spread to the more-stable major U.S. trading partners.

U.S. Inflation. Risk remains exceptionally high in the next six-to-nine months for a combination of massive U.S. dollar selling and heavy Federal Reserve monetization of Treasury debt to boost inflation, and to open the early stages of a U.S. hyperinflation. As discussed in the *Hyperinflation Special Report*, runaway inflation is a virtual certainty by mid-decade.

Defining inflation (deflation) in terms of annual change in the prices of consumer goods and services, consumer prices currently are about as contained as they have been since before the financial crises began to break in 2007, even as measured by the SGS-Alternate CPI measures. Tied to wild swings in oil and related gasoline prices, the CPI began to pick-up sharply in 2008, as oil prices soared, but prices then retreated to a period of short-lived official deflation in 2009, as oil prices collapsed. The current "contained" circumstance will not last, and the problem ahead very likely is not going to be deflation, partially because the Fed has indicated that it will act to prevent deflation, and it has the ability to do so.

First, though, again, as point of clarification, I define inflation in terms of changes in consumer prices, not in terms limited purely to changes in money supply growth (annual broad nominal growth is negative), nor in terms of asset inflation or deflation (a stock market crash does not necessarily lead to contracting consumer prices).

A sharp annual contraction in money supply, as seen at present in annual M3 (the SGS-Ongoing M3 estimate) legitimately can and has raised fears of deflation. Federal Reserve Chairman Bernanke has noted (see his 2002 comments in the *Hyperinflation Special Report*) and effectively confirmed in his recent Jackson Hole, Wyoming speech that a central bank in conjunction with its central government always can debase its currency (create inflation) in order to prevent deflation.

A central bank indeed can do that, if it so desires. The quantitative easing undertaken by Japan never was designed to debase the yen. Similarly, Mr. Bernanke's quasi-effort at dollar debasement in the trillion-dollar-plus expansion of excess bank reserves was aimed specifically at banking system stability, not at creating inflation, per se. The deflation fight, though, is at hand and will be discussed further in the *Systemic Stability* section.

Current projections on the federal budget deficit, U.S. Treasury funding needs, banking industry solvency stress tests, etc. all have been predicated on some form of economic recovery. There is and will be no recovery for the foreseeable future; and the negative implications of that for U.S. funding needs and for systemic stability should act as eventual triggers for massive dumping of the U.S. dollar. Those circumstances also should lead to funding difficulties for the U.S. Treasury, putting the Federal Reserve in the position as lender of last resort to the Treasury. Such lending would be direct monetization of U.S. Treasury debt, which would feed directly into the money supply.

Actions already taken by the Fed and the U.S. Government in the ongoing crises have pushed major U.S. lenders to the brink of abandoning the U.S. dollar as the world's reserve currency, and to the brink of dumping dollar-denominated assets. Keep in mind that a weak U.S. dollar can be extremely inflationary, particularly when dollar-denominated oil prices rise in response to such weakness, as has been seen in the last several years.

Systemic Stability. Threatened with systemic collapse at the time of the 1987 stock crash, then-Federal Reserve Chairman Alan Greenspan began serious efforts to forestall an eventual day-of-reckoning for the economy and financial system, through encouraging massive debt expansion, with leverage built upon leverage. As the economy faltered in early 2007, the system began to fall apart. The financial system did face collapse, and the Fed and the U.S. government did all in their powers -- spent whatever money they thought they had to -- to prevent it. A systemic collapse would have represented a complete functional failure of the U.S. government and the Federal Reserve. Such had to be, and still has to be, avoided at all costs, as far as the government and Fed are concerned. The big problem is there are no viable solutions.

The federal government effectively is bankrupt, unable to meet its long-range obligations or even to cover physically its annual shortfall in operations (see the *Hyperinflation Special Report*). Accordingly, the efforts at fiscal stimulus rapidly are approaching their practical limits, the point at which the U.S. Treasury will have difficulty raising needed funds. There are three options open to the government for meeting its impossible fiscal needs: balancing its books, reneging on its obligations or printing the money it cannot possibly raise through taxation.

The option for balancing the books would mean the U.S. government reversing its ever-evolving social-system policies of the last 75-plus years, abandoning the concept of federal government social programs supporting the income, retirement and health needs of the broad public. The economy cannot expand enough, taxes cannot be raised enough and other expenses cannot be cut enough otherwise to balance the books.

Specifically needed are slashing of the Social Security, Medicare and Medicaid programs, as well as the nascent fiscal shortfalls already building up as a result of the healthcare system control recently seized by the federal government. Such change is an extremely unlikely political possibility in the current system and circumstance, which leaves open the general options of government default on its obligations or government printing of money to meet its obligations. The latter option is the usual and likely one to be taken.

With no easy or politically-practical solutions, the available options all are bad; the choices being made and likely to continue being made are aimed at delaying systemic turmoil as long as possible. Ironically, it likely will be the efforts at saving the system that push the system into its ultimate day-of-reckoning in a hyperinflationary great depression. The general background material provided in the *Hyperinflation Special Report* again is referenced here, as I do not want to get overly repetitive with key points of the broad picture.

Consider, though that the "quantitative easing" entered into by the Fed had minimal impact on the money supply, as it involved mostly the purchase of mortgage-backed securities, with the created excess bank reserves being deposited with Fed, earning interest. As result, bank lending into the normal flow of commerce has been in contraction, and the broad money supply has followed. Now the Fed is considering the possibility of inducing banks to lend, by cutting the interest rate it pays on reserve balances.

The Fed's primary function -- as a private corporation owned by commercial banks -- is to protect the banking system. Supporting economic growth and containing inflation are secondary concerns, but the renewed economic threat now also can shatter the fragile appearance of banking-system stability. Indeed, the banking system is far from stable, which is one reason lending is down.

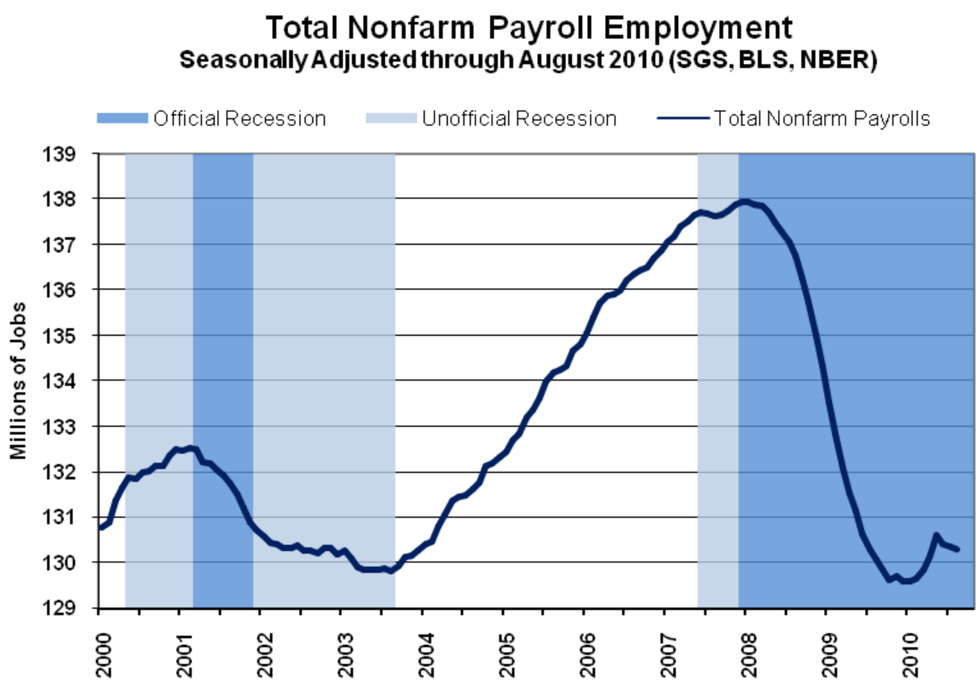
Separately, a number of states will need financial bailouts, insolvent pension funds will seek government backing, the unemployed will be looking for greater support, etc., and all these pressures will be on top of a renewed decline in federal tax revenues. The most likely course of action here remains ongoing efforts to spend or create whatever money is needed to keep the system from collapsing. Where the options are for devil's choices, the one that buys the most time and is least politically painful usually is the one chosen.

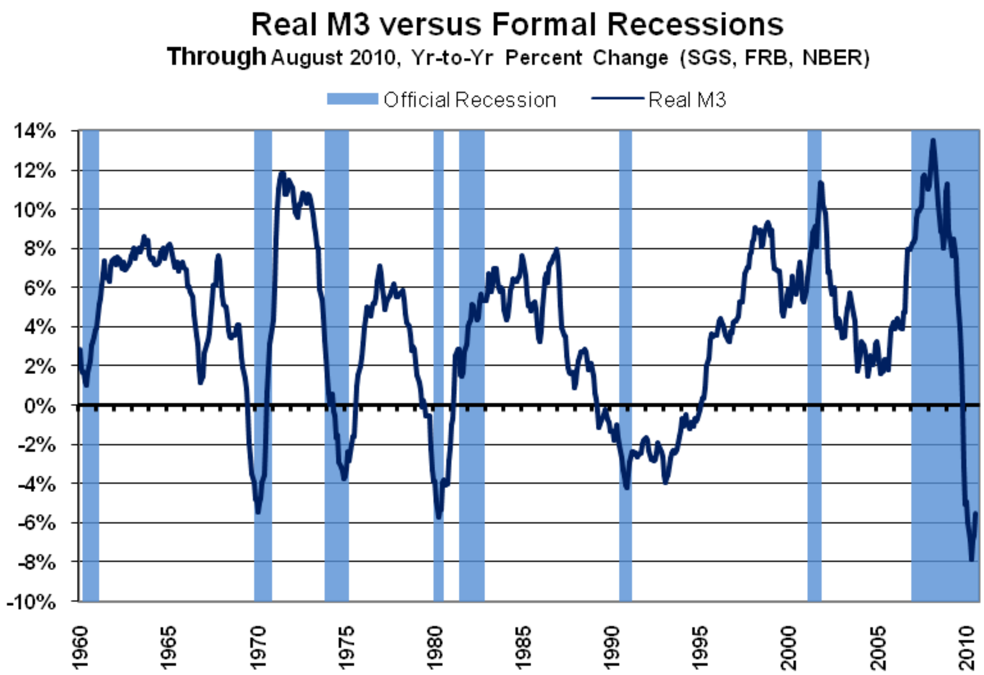
Greenspan abandoned the U.S. dollar for a while following the 1987 stock crash. The dollar and foreign investment likely will become secondary concerns for political Washington against a U.S. populace looking to kick out the political miscreants -- both sides of the aisle -- who have lead the U.S. system into this crisis over decades. The ultimate cost in domestic inflation will be horrendous.

U.S. Financial Markets. In these circumstances, the financial markets likely will be highly unstable and volatile. Looking at the longer term, strategies aimed at preserving wealth and assets continue to make sense. For those who have their assets denominated in U.S. dollars, physical gold and silver remain primary hedges, as do stronger currencies such as the Canadian and Australian dollars and the Swiss franc. Holding assets outside the U.S. also may have some benefits.

Graphs. The first of the following graphs shows the seasonally-adjusted monthly level of payroll employment since 2000, with no adjustments made for census hiring in 2000 or in 2010. The shaded areas of "unofficial recession" are as suggested by shifts in payroll employment. The 2000 recession was longer and deeper than officially reported, and it could be considered an initial downleg in a 2000/2007 double-dip recession.

The second graph is the latest version of the year-to-year change in real M3 growth, where the series turning negative always has signaled an economic downturn or an intensifying recession. The downturn in December 2009 signaled the current re-intensification of the recession/depression.




Real M3 versus Formal Recessions
Through August 2010, Yr-to-Yr Percent Change (SGS, FRB, NBER)
Official Recession
Real M3
14%
12%
10%
8%
6%
4%
2%
0%
-2%
-4%
-6%
-8%
-10%
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
2010

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