John Williams'
# Shadow Government Statistics
*Analysis Behind and Beyond Government Economic Reporting*

**COMMENTARY NUMBER 349**
**Crisis in Economic Reporting, Systemic Liquidity**

**February 7, 2011**

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**Seasonal Adjustment Crisis:**
**Month-to-Month Comparisons Have Become Meaningless for Key Series**

**Broad Money Supply Appears to Be Contracting Month-to-Month**

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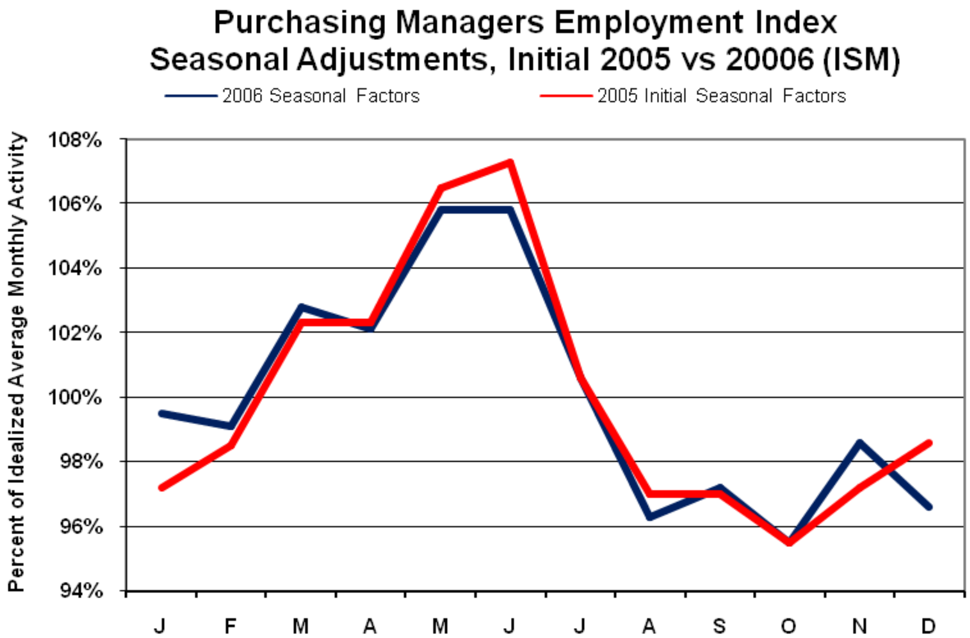
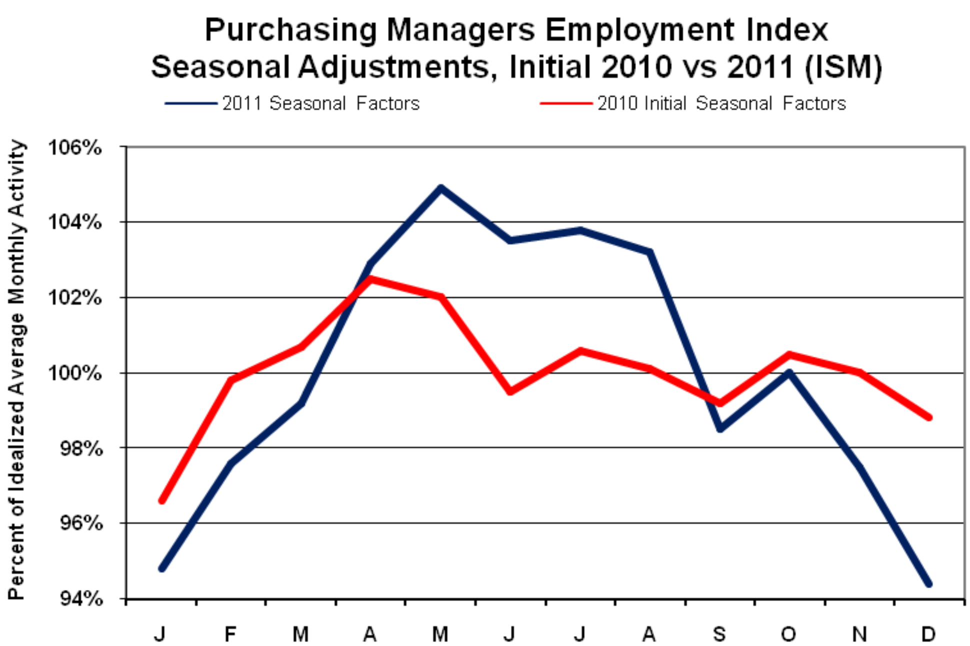
*PLEASE NOTE: This morning's brief* Commentary *covers areas that were intended for Friday's* Commentary No. 348, *but which were delayed by time constraints related to assessing the payroll benchmark revisions. The next regular* Commentary *is planned for Friday, February 11th, following release of December trade deficit data.*

*-- Best wishes to all, John Williams*

**Crisis in Seasonal Adjustments -- Monthly Economic Reporting in Unprecedented Turmoil.** Due to repetitious patterns in business activity -- ranging from the impact of holidays and the school year to the effects of seasonal weather patterns -- most economic series are seasonally-adjusted when viewed in terms of month-to-month or quarter-to-quarter change. That is, the reporting agencies attempt to remove regular non-economic patterns of activity, so that what is left in reported period-to-period change generally is reflective of changes in regular economic activity. While this process has worked reasonably well in the post-World War II era of modern economic reporting, it has fallen apart in the last several years due to the effects of the extraordinarily protracted and severe economic contraction.



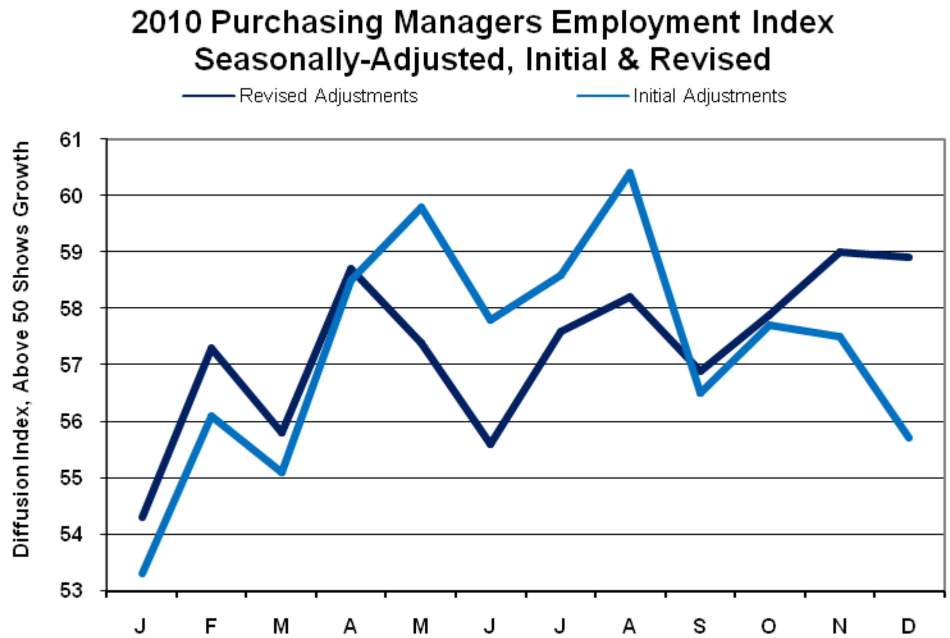




Simply put, the severe decline in economic activity has overwhelmed traditional patterns of seasonal activity, destabilizing the calculation of seasonal-adjustment factors using the traditional mathematical models that are based on a number of years of activity, with the greatest weighting given to the most recent period's patterns. As a result, key economic series such as retail sales and the purchasing managers surveys, at present, are not showing meaningful month-to-month reporting. The issue here is separate from problems in surveying businesses that no longer are participating in the surveys due to going out of business or other factors.

The issue can be demonstrated with the relatively simple ISM purchasing managers survey. Each of its indices (except prices) is seasonally-adjusted and has a problem similar to the one shown here with the employment index. If seasonal adjustments were stable and working as expected, that stability should be evident year-to-year. Looking at the two graphs preceding, the first shows the initial seasonal-factor estimates for 2005 and 2006, before the recent economic upheaval. The patterns are reasonably stable year-to-year, when contrasted with the second graph, which shows the initial seasonals for 2010 and 2011 with significant differences.

Along with the 2011 seasonal-factor estimates, however, the 2010 seasonals were revised so as to be more consistent with the new pattern estimated for 2011. The monthly unadjusted index is divided by the seasonal-adjustment factor to come up with the adjusted number. Consider the following graph, which shows the unadjusted employment index for 2010.


The next graph shows the unadjusted data seasonally-adjusted both for the initial seasonal factors as reported through December 2010 (light-blue line) and for the seasonal factors as revised along with the production of the initial 2011 estimate of seasonal factors (dark-blue line) and as currently reported.




So, did the employment picture weaken or strengthen in May? How about November? The answers depend on the seasonal adjustments used. There has been no change whatsoever to the underlying raw, unadjusted data. Unfortunately, there is no consistency or stability to the adjustment patterns at present.

In many respects, the financial markets and analysts, and policy makers, are partially blind as to what is happening in the economy. Such can be extraordinarily dangerous, particularly when the mind starts filling in missing details as to what is not there. These are times to assess the numbers carefully, to use common sense and to consider the underlying fundamentals. If consumption is picking up, how is the consumer paying for it? Beyond short-term stimulus giveaways, is consumer income up, is consumer debt expanding meaningfully?

**Sharp Declines in Seasonally-Adjusted January U.3 and U.6 Unemployment Rates Revisited.** As noted in Friday's *Commentary No. 348*, the January 2011 seasonally-adjusted headline (U.3) unemployment rate declined to 9.0% from 9.4% in December, while, unadjusted, it rose to 9.8% in January from 9.1% in December. In like manner the broader January U.6 unemployment rate (including short-term discouraged workers and those forced to work part-time for economic reasons) dropped to a seasonally-adjusted 16.1% from 16.7% in December. Not seasonally-adjusted, though, U.6 rose to 17.3% in January from 16.6% in December.

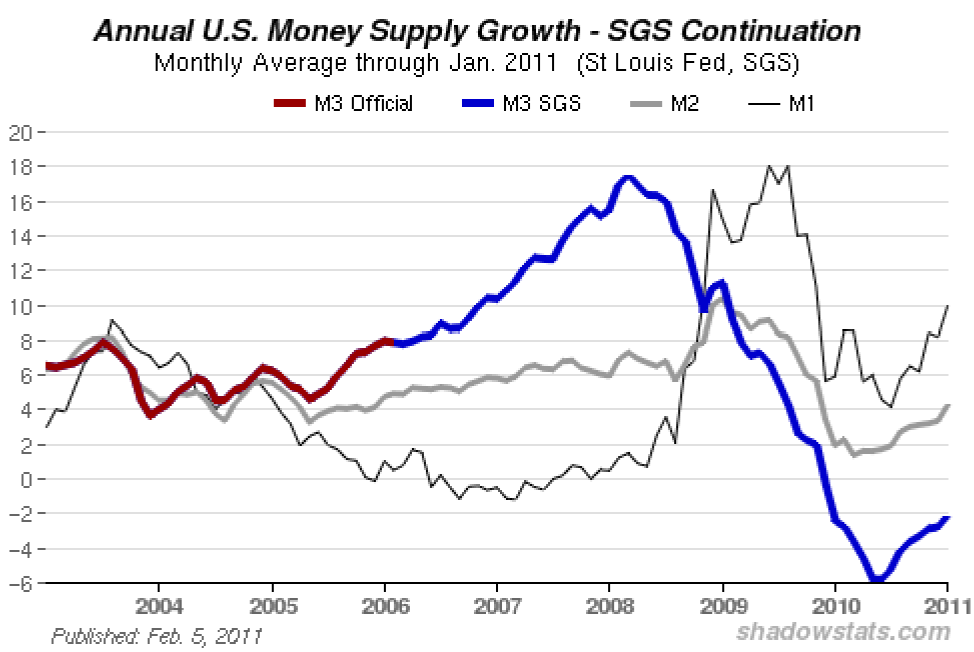
As noted in the *Commentary*, the seasonally-adjusted unemployment rates appear to have been affected by highly unstable seasonal factors that are artifacts of the severe and extraordinarily protracted downturn in U.S. economic activity, not from changing seasonal patterns, as discussed in today's opening section.

While I'm still reviewing seasonal adjustment detail over time in the series -- particularly with part-employment -- two other issues here are worthy of note. Some in the financial media noted that the participation rate (labor force as a percent of population) hit a new low in January. This is an important area, where a declining pattern of participation tends to reflect a growing population of both short- and long-term "discouraged" workers, who have not sought work in the last four weeks. While excluded from the labor force, these individuals otherwise meet all the qualifications of being unemployed, with short-time (less than a year) discouraged workers in U.6, and the long-term (more than year) in the SGS Alternate Unemployment Rate.

The decline in the participation in January was not real, however, just a result of the adjustments made to population estimates, as revamped each January. The new series, which is not comparable with earlier reporting (i.e. December), does show the lower participation rate on an inconsistent basis, so perhaps a special adjustment might be due for the SGS measure.

Also, the short-term discouraged worker measure, which is included in U.6 and never is seasonally adjusted, was reported to have fallen by an unusually large 325,000 in January, versus December. As the counted discouraged workers gain in seniority, once they pass one year on the government's rolls, they no longer are counted or tracked by the BLS. They do enter the realm of the long-term discouraged worker, however, which is estimated in the SGS measure. Such likely was at work in January, along with possible other unusual effects from the population re-estimates. This all is under review, but the January U.3 and U.6 data never may move beyond the phase of simply reflecting poor-quality reporting.

**M3 Fails to Pick-Up, Despite QE2.** With 24-plus days of reporting in place for January 2011, the initial SGS Ongoing M3 estimate for the seasonally-adjusted monthly average shows a continuing year-to-year contraction, down 2.2% in January versus a 2.8% contraction in December, as shown in the graph following. Such contrasts with estimated year-to-year gains in M1 of 9.9% in January versus 8.2% in December, and in M2 of 4.3% in January versus 3.4% in December.



In month-to-month terms, the monetary data can be subject to similar seasonal-adjustment distortions seen in the economic data, although the Fed is aware of the problem and has been working to adjust for same. That said, and with the usual cautions about the month-to-month numbers, M3 contracted month-to-month in January 2011 for the fourth straight month, down roughly 0.3% in January versus December, which in turn was down by about 0.2% from November. The respective monthly gains in M1 in January and December were 0.9% and 0.6%, and in M2 were 0.3% and 0.2%. The monthly gains in M2 that have received some touting in the financial press have been more than offset by declines in the M3 components still published by the Fed: institutional money funds and large time deposits.

Accordingly the recent monthly increases in M1 and M2 reflected nothing more than cash flowing out of M3 accounts into M1 accounts. The M1 and M2 increases were not a direct result of the Fed's monetization of Treasury debt or of renewed growth in the monetary base, yet. Such can seen, though, only using a broader money measure than M2.

The lack of growth in the M3 measure -- traditional broadest money supply measure used by the Fed until its abandonment in March 2006 -- suggests a re-intensifying systemic solvency crisis, as does the continued lack of growth in bank lending. The implications here remain extremely negative for broad economic activity. On the inflation front, however, where there is an overhang of $7 trillion or so outside the United States -- being held at the whim of dollar investors -- that has to be considered in the U.S. monetary picture. Higher prices already are being seen in a number of dollar-denominated commodities, ranging from oil to food. The higher prices are anticipating and fueling the early stages of Mr. Bernanke's desired debasement of the dollar. This area has been discussed previously and will be detailed anew in the forthcoming updated *Hyperinflation Special Report.*

**Week Ahead.** Given the unfolding reality of an intensifying double-dip recession and more-serious inflation problems than generally are anticipated by the financial markets, risks to reporting will tend towards higher-than-expected inflation and weaker-than-expected economic reporting in the months ahead. Increasingly, previously unreported economic weakness should show up in prior-period revisions.

***Trade Balance (December 2010).*** The estimated December 2010 trade deficit is scheduled for release on February 11th. Anything shy of a significant improvement in the inflation-adjusted deficit should have significant downside revision implications for the next estimate of fourth-quarter 2010 GDP (due for release on February 25th). Consensus expectations (per Briefing.com) are for a widening in the December deficit, not for a sharp improvement, which is reasonable.

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