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

**COMMENTARY NUMBER 400**
**Budget Deficit Reality, October CPI, Industrial Production**

**November 16, 2011**

---

**GAAP-Based 2011 Federal Deficit Likely Within Five- to Seven-Trillion Dollar Range**

**Effects of High Oil Prices Still Spreading in Broad Economy**

**October's Annual Inflation: 3.5% (CPI-U), 3.9% (CPI-W), 11.1% (SGS)**

**Real Retail Sales and Industrial Production Gained in October**
**But the Series Share Inflation-Adjustment Issues**

---

*PLEASE NOTE: The next regular* Commentary *is scheduled for tomorrow, Thursday, November 17th, covering October housing starts. It also will include a* Special Commentary *discussing underlying U.S. economic reality.*

*—Best wishes to all, John Williams*

## SPECIAL COMMENTARY – BUDGET DEFICIT REALITY

**U.S. Federal Budget Deficit Reality.** On November 23rd, just one week from today, the Congressional Super Committee is due to announce a mandatory plan for cutting the federal budget deficit. Ostensibly, the package to be produced will provide at least a 1.2-trillion dollar deficit reduction over ten years. Even if the Committee can reach an agreement—which is highly problematic—the deal will not be meaningful. Beyond the usual political shenanigans that can be played by the politicians post-2012 (and most spending and/or tax changes in the package likely would not be effective until after the election), consider the following:

- Deficit reduction of 1.2-trillion dollars over ten years is little more than statistical noise, given the overly optimistic assumptions underlying the deficit projections.

- The actual annual deficit (on a generally-accepted-accounting-principles [GAAP] basis) likely will be reported in the range of five -to seven-trillion dollars for 2011, with the GAAP shortfalls in 2012 and beyond likely to show ongoing deterioration, irrespective of the Super Committee's actions.

The White House Office of Management and Budget (OMB) assumes positive economic growth into the future, underlying its budget projections. Assumptions in the September 2011 *Mid-Session Review* already have gone astray, in the wrong direction. The annual average real GDP growth for 2011 was assumed at 2.6%. With three quarters of reporting now in place, it would surprising if the actual 2011 number got as high as 1.7%). Assumed GDP growth improves into the future, peaking at 4.0% in 2014, and then tapering off into the next decade. As will be discussed in tomorrow's *Special Commentary—Underlying Economic Reality*, a more realistic outlook would show a contracting GDP for at least the next several years.

The OMB also assumes average CPI-U inflation of 2.0% or less for 2012 through 2015, and then 2.1% thereafter. The projection for 2011 was 2.8%, but with 10 months now reported, inflation for the year is unlikely to be less than 3.2%. A more realistic outlook would show higher consumer inflation for at least the next several years.

To the extent that reported GDP growth is weaker than assumed, and that CPI-U inflation is stronger than assumed, the resulting federal budget deficit and borrowing needs of the U.S. Treasury will be worse than projected. Bad forecasting of the close-in years has disproportionately large impact on longer-range forecasts such as a 10-year federal budget deficit projection.

***GAAP-Based Deficit.*** The U.S. Treasury reported a cash-based operating deficit for the U.S. government of 1.299-trillion dollars in fiscal 2011 (year-ended September 30th). That was against a 1.294-trillion dollar deficit in 2010. The cash-based reporting has been gimmicked since the days of President Lyndon Johnson, when government accounting began using the cash surplus (tax receipts versus outlays) dedicated to Social Security as part of the general fund. As a result, for decades, the federal government's reported deficit was understated due to the inclusion of the Social Security cash surplus. Recently, though, the Social Security cash flow turned negative.

The simple cash-based system was gimmicked anew, when the Treasury started to count some of its recent bailout outlays as "investments." Accordingly, I view the headline deficits as not too meaningful, looking instead at changes in the gross federal debt for indications of cash flow, and to the GAAP-based accounting for meaningful deficit numbers.

My best estimate for fiscal 2010 remains that the GAAP-deficit—based on considering consistent accounting and one-time charges, and including the net present value of unfunded liabilities in Social

Security, etc.—was roughly 5.3-trillion dollars (see *Commentary No. 340* for details). With continued deterioration in the unfunded liabilities for Social Security, Medicare, etc., and with possible accounting changes (such as the handling of Fannie Mae and Freddie Mac, which largely have been excluded from the accounting), the GAAP-based federal deficit for fiscal 2011 likely was in the range of five- to seven-trillion dollars.

That would put the ratio of gross U.S. government debt and obligations to GDP closing in on six-to-one, the worst of any major Western power. It is difficult to develop numbers for other countries that are on a consistent basis, but I hope to have a well-vetted table of such detail for the revision to the *Hyperinflation Report*. My best estimate remains that the next-worst ratio within the major economies is the United Kingdom.

It is the GAAP-based deficit that shows the ultimate insolvency of the U.S. government. With an annual deficit in excess of five-trillion dollars, the government could tax salaries and wages at 100% and an annual deficit would remain. The government could eliminate every penny of government spending, except for Social Security and Medicare, and the annual deficit would remain.

A cut of $1.2 trillion dollars over ten years is not too meaningful in such a circumstance. The focus needs to be on balancing the GAAP-based not the cash-based deficit.

The U.S. Treasury is scheduled to publish its formal GAAP-based 2011 financial statements on the U.S. government on December 15th. A fully updated and revamped *Hyperinflation Report* will be published soon thereafter.

***Rest-of-the-World and the Pending Deficit Reduction Program.*** To the extent that long-term solvency could be restored to the United States government, the required actions would be extremely painful to the populace. It became clear during the recent debt-ceiling negotiations that even looking at hints of what had to be done was politically impossible for those currently controlling the Congress and the White House. Without consistent and very strong political will—which I see largely as lacking in Washington—and without concurrent extraordinary actions, the U.S. economy remains at high risk of devolving quickly into a hyperinflationary great depression. The timing here has been accelerated rapidly by the Federal Reserve and the federal government taking only extreme stop-gap measures that have bought limited time, but that have done little to resolve the U.S. systemic-solvency and economic crises of the last four-to-five years.

The global markets have been in turmoil since the debt-ceiling negotiations ended with the Super Committee solution. It would not take much intensification of U.S. political turmoil to refocus global financial-market attention on the long-range U.S. insolvency—as things stand—and to trigger renewed heavy selling of the U.S. dollar and dollar-denominated assets. More will follow in tomorrow's *Hyperinflation Watch*. Again, the general broad outlook has not changed.

**Executive Summary—Economic Reporting.** With tomorrow's (November 17th) *Special Commentary*, on underlying economic reality, today's economic comments are limited. The general outlooks on the economy, inflation and systemic solvency have not changed from those discussed in the *Hyperinflation Special Report (2011)* and in recent *Hyperinflation Watch* sections. The *Hyperinflation Watch* section will be published next and fully updated in tomorrow's missive.

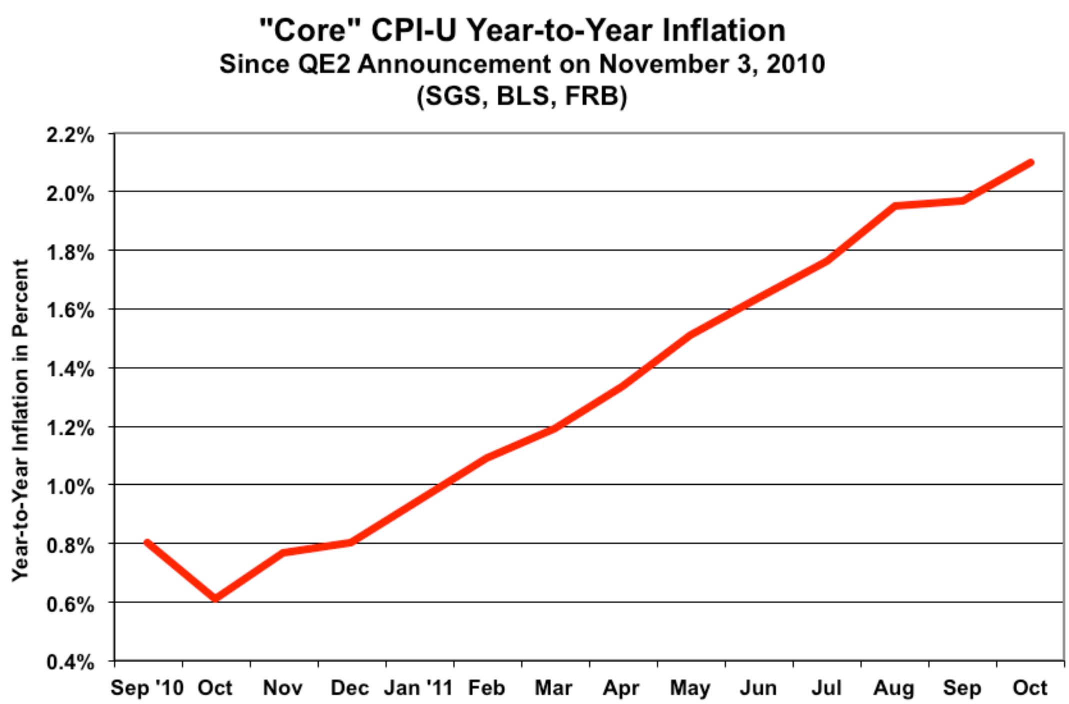
***October Real Retail Sales and Industrial Production.*** Both inflation-adjusted retail sales and industrial production were reported with solid monthly gains in October, but there are broader inflation issues that will be addressed in tomorrow's *Special Commentary*. Seasonally-adjusted real retail sales gained 0.6% (versus 0.5% not adjusted for inflation) for the month of October, thanks to the 0.1% monthly decline in the CPI. In September, real sales gained 0.8% (versus 1.1% before inflation adjustment).

Seasonally-adjusted October industrial production jumped by 0.7% in the month, versus a revised 0.1% monthly decline in September. September production initially was reported with a 0.2% gain.

***October Consumer Price Index (CPI).*** A 4.3% monthly decline in October gasoline prices was more than could be offset with a small positive seasonal-adjustment, and the adjusted CPI-U notched 0.08% lower for the month as a result. Against stronger monthly inflation in October 2010, the year-to-year annual CPI-U inflation pace softened to 3.53% from 3.87% in September. Outside of the last several months, though, the October annual inflation still was the highest since October 2008.

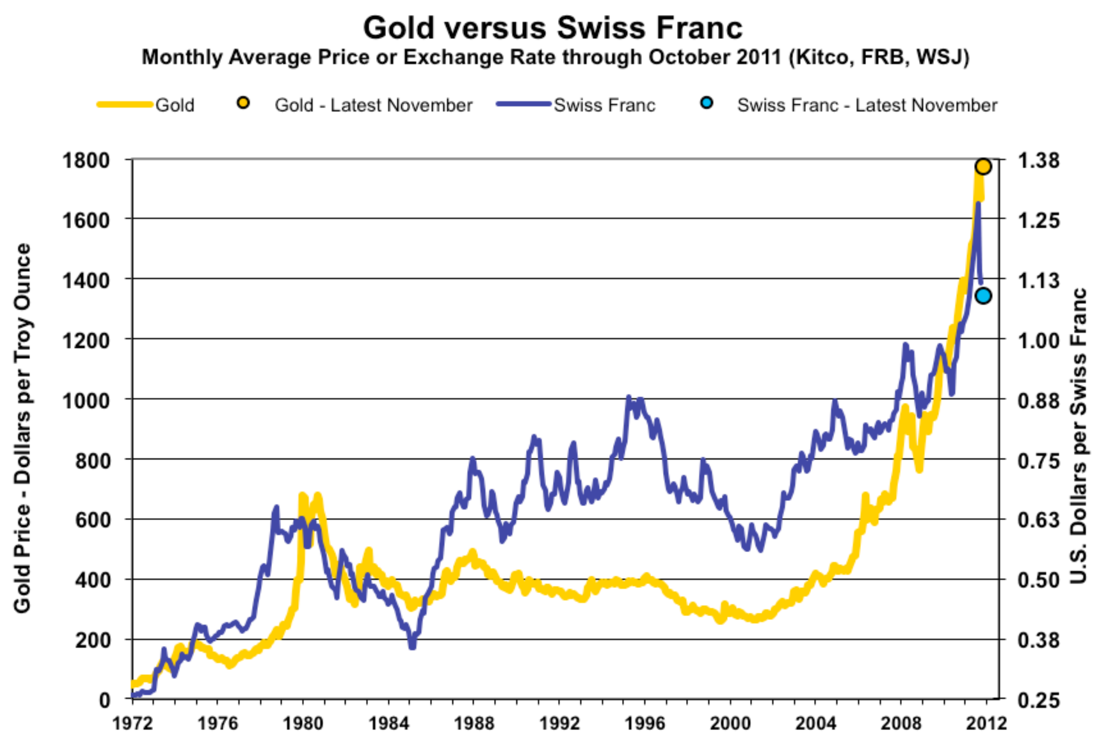
The SGS-Alternate Consumer Inflation Measures showed lower annual inflation in tandem with the underlying CPI-U series. The 1990-methodology-based alternate measure saw annual inflation at 6.9% in October, down from 7.2% in September, while the 1980-methodology-based alternate measure saw annual inflation at 11.1% in October, versus 11.5% in September.

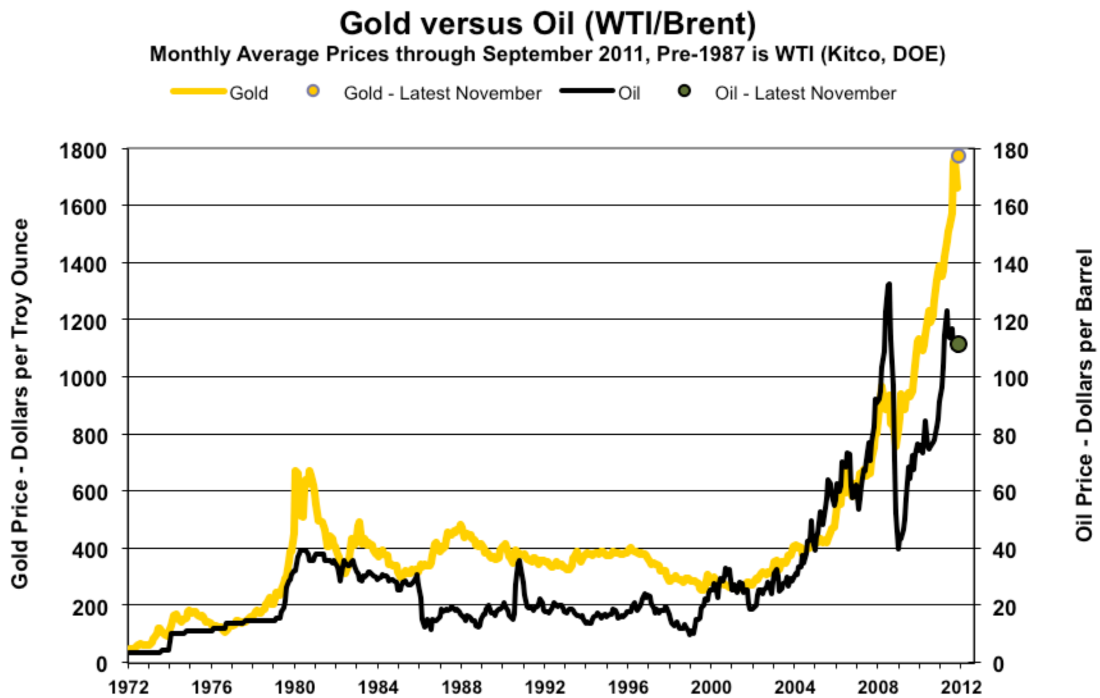
October's adjusted monthly decline likely will not be repeated in November. Although seasonal factors for gasoline prices turn negative in November, gasoline prices in November have held even with October, so far, and could increase in tandem with generally rising oil prices. Inflation in non-energy measures increasingly will provide a broad-based rise in prices. In the works is a round of wage/salary and cost adjustments triggered by 4% annual inflation already seen in official CPI reporting.

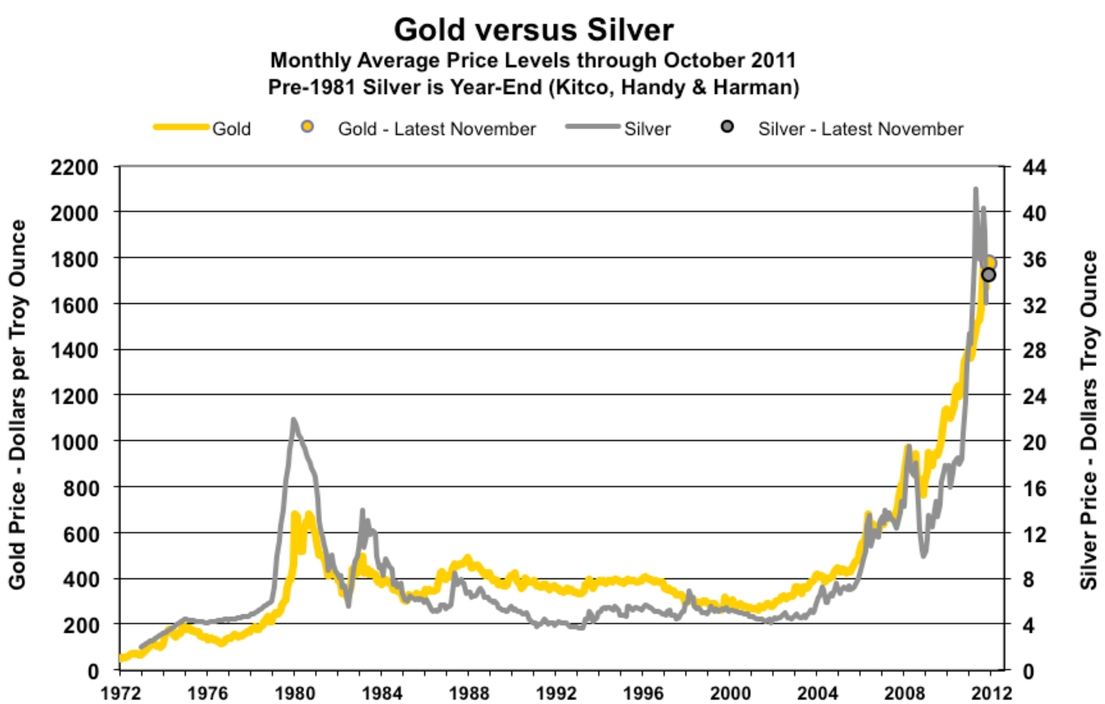


Reflecting the broadening inflation problem, the CPI-U's annual "core" inflation rate has risen now for twelve straight months, since the Fed introduced QE2. As shown in the following graph, the annual core rate rose to 2.10% in October versus 1.97% in September, and was up from 0.61% in October 2010.

The usual graphs of the price of gold versus the Swiss franc/U.S. dollar, price of oil and price of silver follow. The plots are suggestive of extreme volatility seen recently in the financial markets. The precious metals and the stronger currencies remain the primary long-range hedges against all the difficulties that lie ahead for the U.S. dollar, as will be discussed in tomorrow's *Hyperinflation Watch.*




Gold versus Oil (WTI/Brent)
Monthly Average Prices through September 2011, Pre-1987 is WTI (Kitco, DOE)
Gold
Gold - Latest November
Oil
Oil - Latest November
Gold Price - Dollars per Troy Ounce
Oil Price - Dollars per Barrel
1800
1600
1400
1200
1000
800
600
400
200
0
180
160
140
120
100
80
60
40
20
0
1972
1976
1980
1984
1988
1992
1996
2000
2004
2008
2012


Gold versus Silver
Monthly Average Price Levels through October 2011
Pre-1981 Silver is Year-End (Kitco, Handy & Harman)
Gold
Gold - Latest November
Silver
Silver - Latest November
Gold Price - Dollars per Troy Ounce
Silver Price - Dollars Troy Ounce
2200
2000
1800
1600
1400
1200
1000
800
600
400
200
0
44
40
36
32
28
24
20
16
12
8
4
0
1972
1976
1980
1984
1988
1992
1996
2000
2004
2008
2012

## REPORTING DETAIL

### CONSUMER PRICE INDEX—CPI (October 2011)

**Short-Lived Drop in Gasoline Prices Hit October Consumer Inflation.** A sharp monthly decline in October gasoline prices pulled the adjusted CPI-U down for the month by 0.08%. Against stronger monthly inflation in October 2010, the year-to-year annual CPI-U inflation pace softened to 3.53% from 3.87% in September. Outside of the last several months, though, the October annual inflation still was the highest since October 2008.

Seasonal factors for gasoline prices turn negative in November, but gasoline prices in November have held even with October, so far, and could increase in tandem with generally rising oil prices. Nonetheless, inflationary pressures from already high oil prices spread further into the broad economy in October, with the annual "core" inflation rate rising to 2.10% from 1.97% in September.

### *Notes on Different Measures of the Consumer Price Index*

*The Consumer Price Index (CPI) is the broadest inflation measure published by the U.S. Government, through the Bureau of Labor Statistics (BLS), Department of Labor:*

*The* ***CPI-U (Consumer Price Index for All Urban Consumers)*** *is the monthly headline inflation number (seasonally adjusted) and is the broadest in its coverage, representing the buying patterns of all urban consumers. Its standard measure is not seasonally adjusted, and it never is revised on that basis except for outright errors.*

*The* ***CPI-W (CPI for Urban Wage Earners and Clerical Workers)*** *covers the more-narrow universe of urban wage earners and clerical workers and is used in determining cost of living adjustments in government programs such as Social Security. Otherwise its background is the same as the CPI-U.*

*The* ***C-CPI-U (Chain-Weighted CPI-U)*** *is an experimental measure, where the weighting of components is fully substitution based. It generally shows lower annual inflation rate than the CPI-U and CPI-W. The latter two measures once had fixed weightings—so as to measure the cost of living of maintaining a constant standard of living—but now are quasi-substitution-based.*

*The* ***SGS Alternative CPI-U Measures*** *are attempts at adjusting reported CPI-U inflation for the impact of methodological change of recent decades designed to move the concept of the CPI away from being a measure of the cost of living needed to maintain a constant standard of living.*

***CPI-U.*** The BLS reported today (November 16th) that the seasonally-adjusted October 2011 CPI-U declined by 0.08% (down by 0.21%, unadjusted) for the month. That followed a gain of 0.30% (up by 0.15%, unadjusted) in September. The October reporting reflected an unadjusted 4.3% drop in monthly average gasoline prices (the Department of Energy reported an unadjusted 4.4% decline), but the unadjusted BLS estimate narrowed to a seasonally-adjusted monthly contraction of 3.1%. Gasoline-price seasonal-adjustments shift back to depressing adjusted reported gasoline inflation in November.

October's unadjusted year-to-year CPI-U inflation fell back to 3.53% from 3.87% in September.

The October report, however, showed still-greater inflationary pressures from the spread of higher energy prices into the broad economy (see the graph and comments in the *Executive Summary)*. On an annual basis, "core" CPI-U inflation moved higher for the 12th straight month, up to 2.10% in October, from 1.97% in September. When Fed Chairman Bernanke used his jawboning in a successful effort to debase the U.S. dollar in the global markets, in advance of announcing QE2 in November 2010, annual "core" inflation was at 0.61%.

Year-to-year total CPI-U inflation would increase or decrease in next month's November 2011 reporting, dependent on the seasonally-adjusted monthly change, versus the 0.12% gain in the adjusted monthly level reported for November 2010. I use the adjusted change here, since that is how consensus expectations are expressed. To approximate the annual unadjusted inflation rate for November 2011, the difference in November's headline monthly change (or forecast of same) versus the year-ago monthly change should be added to or subtracted directly from October 2011's reported annual inflation rate of 3.53%.

***CPI-W.*** The narrower, seasonally-adjusted CPI-W, which has greater weighting for gasoline than does the CPI-U, declined by 0.14% (down by 0.29% unadjusted) in October, following September's gain of 0.37% (up by 0.16% unadjusted).

Unadjusted, October 2011's year-to-year CPI-W inflation was 3.92%, versus a 4.38% annual increase in September.

***C-CPI-U.*** The Chain-Weighted CPI-U—the fully substitution-based series that gets touted as a replacement by CPI by opponents to the existing CPI-U and CPI-W and inflation apologists—including a number of politicians looking to cut deficit spending by using the C-CPI-U to reduce Social Security COLA adjustments—is reported only on an unadjusted basis. Year-to-year inflation eased to 3.36% in October from 3.71% in September.

***Alternate Consumer Inflation Measures.*** Adjusted to pre-Clinton (1990) methodology, annual CPI inflation was roughly 6.9% in October 2011, versus 7.2% in September, while the SGS-Alternate Consumer Inflation Measure, which reverses gimmicked changes to official CPI reporting methodologies back to 1980, eased to about 11.1% (11.12% for those using the extra digit) in October, from about 11.5% in September.

The SGS-Alternate Consumer Inflation Measure adjusts on an additive basis for the cumulative impact on the annual inflation rate of various methodological changes made by the BLS (the series is not recalculated). Over the decades, the BLS has altered the meaning of the CPI from being a measure of the cost of living needed to maintain a constant standard of living, to something that no longer reflects the constant-standard-of-living concept. Roughly five percentage points of the additive SGS adjustment reflect the BLS's formal estimate of the annual impact of methodological changes; roughly two percentage points reflect changes by the BLS, where SGS has estimated the impact not otherwise published by the BLS.

***Gold and Silver Highs Adjusted for CPI-U/SGS Inflation.*** Despite the September 5th historic-high gold price of $1,895.00 per troy ounce (London afternoon fix), and despite the multi-decade-high silver price of $48.70 per troy ounce (London fix of April 28th), gold and silver prices have yet to re-hit their 1980 historic levels, adjusted for inflation. The earlier all-time high of $850.00 (London afternoon fix, per Kitco.com) of January 21, 1980 would be $2,474 per troy ounce, based on October 2011 CPI-U-adjusted dollars, $8,695 per troy ounce based on SGS-Alternate-CPI-adjusted dollars (all series not seasonally adjusted).

In like manner, the all-time high price for silver in January 1980 of $49.45 per troy ounce (London afternoon fix, per silverinstitute.org), although approached earlier this year, still has not been hit since 1980, including in terms of inflation-adjusted dollars. Based on October 2011 CPI-U inflation, the 1980 silver price peak would be $144 per troy ounce and would be $506 per troy ounce in terms of SGS-Alternate-CPI-adjusted dollars (again, all series not seasonally adjusted).

As shown on page 43 of the *Hyperinflation Special Report (2011)*, over the decades, the price of gold has compensated for more than the loss of the purchasing power of the U.S. dollar as reflected by CPI inflation, while it has effectively fully compensated for the loss of purchasing power of the dollar based on the SGS-Alternate Consumer Price Measure (1980 Methodologies Base).

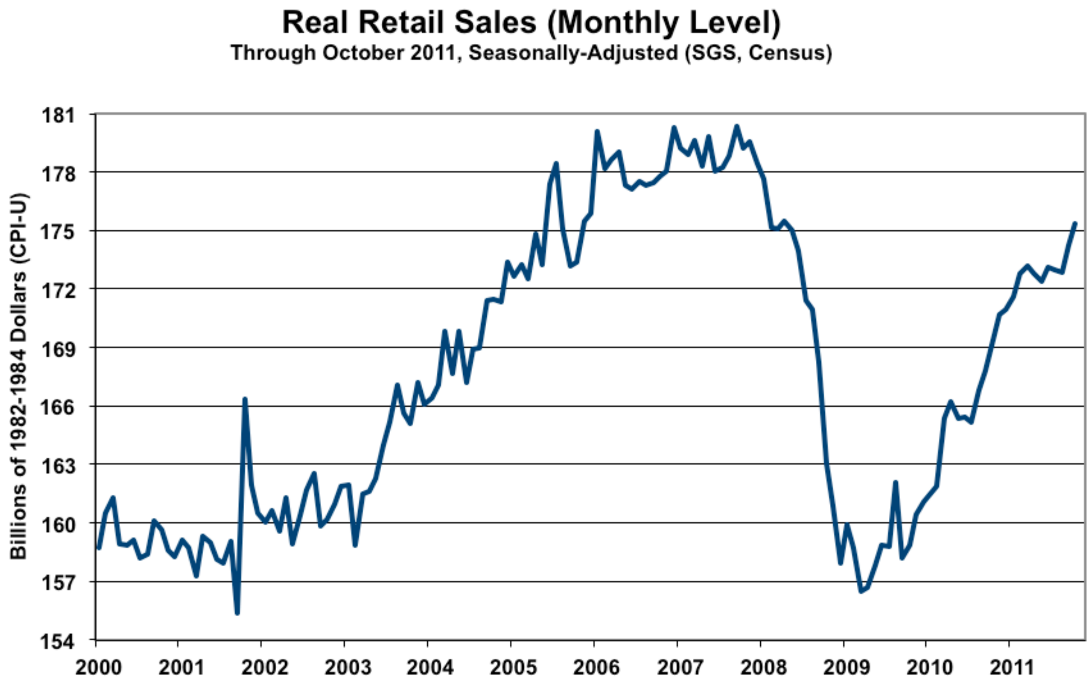
***Real (Inflation-Adjusted) Retail Sales.*** Based on the October 2011 CPI-U reporting, inflation- and seasonally-adjusted October 2011 retail sales rose by 0.62% for the month, where, before inflation adjustment, the current number was up by 0.54% (see *Commentary No. 399* for details of the nominal reporting). Real September retail sales revised to a monthly gain of 0.83% (initially 0.81%), where nominal (not-adjusted for inflation) sales in September revised to a gain of 1.14% (previously 1.13%).

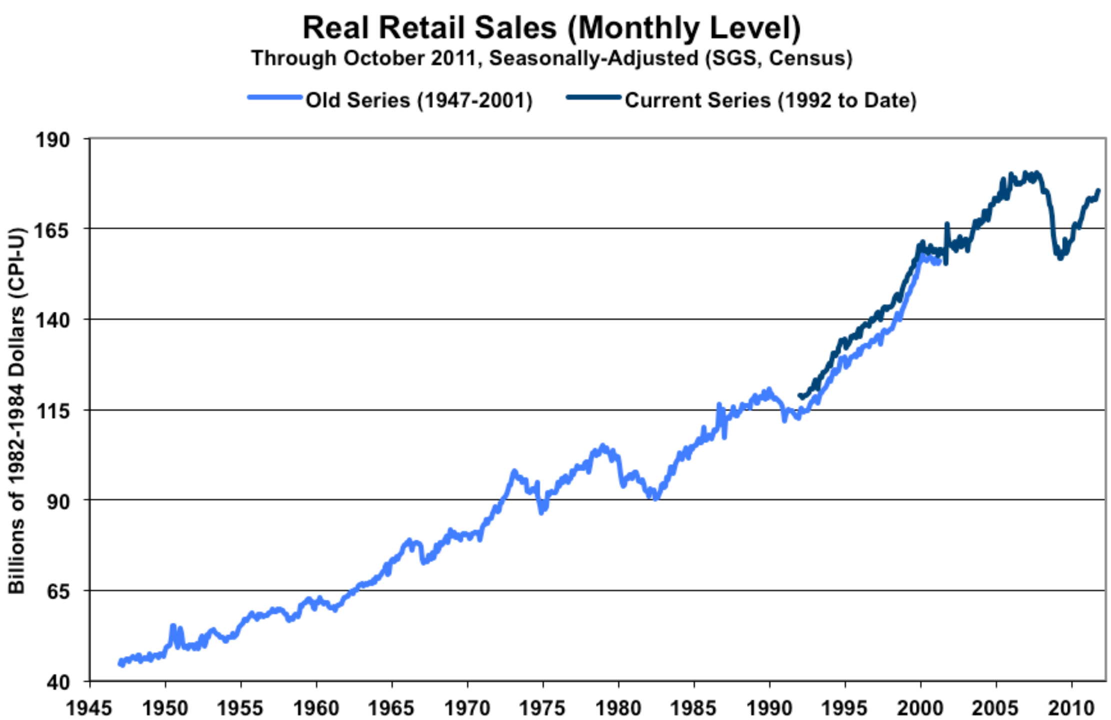
October's real retail sales rose at a somewhat slower year-to-year pace of 3.56%, versus a revised 3.89% (previously 3.87%) annual gain reported for September.

The ongoing "recovery" in real retail sales is reflected in the following graphs, which show the latest monthly levels of inflation- and seasonally-adjusted activity. The first of these shows close historical detail for the period beginning in 2000; the second shows the same data in historical context since World War II.

As noted in earlier writings, using the SGS Alternate-CPI Inflation estimates for deflation of the retail series would not have shown an ongoing rise in activity for the last year or so. This will be shown in tomorrow's (November 17th) *Special Commentary—Underlying Economic Reality*. It has been my preference here, and wherever otherwise possible, to use the official estimates (the series here is as calculated by the St. Louis Fed), since that eliminates a level of argument over what is being reported. As official consumer inflation picks up further, and as overall retail sales suffer from the ongoing consumer liquidity squeeze, these data should turn down meaningfully in what eventually will become a formal double-dip recession.

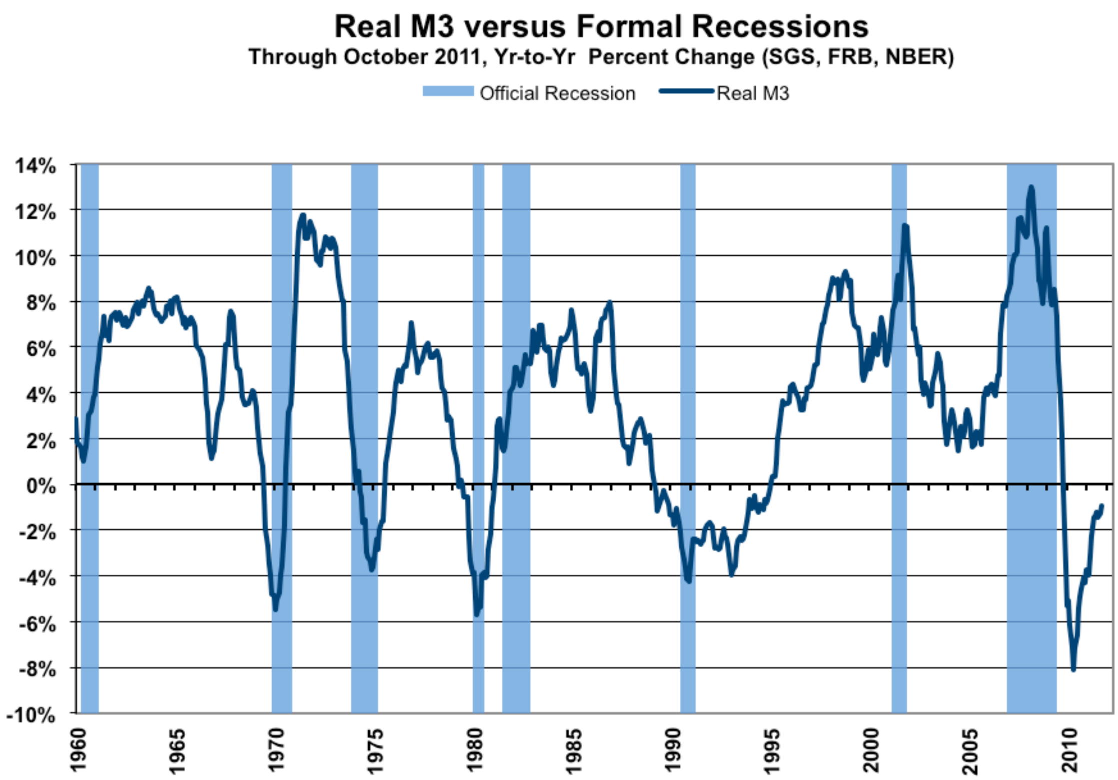
 


Real Retail Sales (Monthly Level)
Through October 2011, Seasonally-Adjusted (SGS, Census)
Billions of 1982-1984 Dollars (CPI-U)
181
178
175
172
169
166
163
160
157
154
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011


Real Retail Sales (Monthly Level)
Through October 2011, Seasonally-Adjusted (SGS, Census)
Old Series (1947-2001)
Current Series (1992 to Date)
Billions of 1982-1984 Dollars (CPI-U)
190
165
140
115
90
65
40
1945
1950
1955
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
2010

There has been no change in underlying fundamentals that would support a sustainable turnaround in personal consumption or in general economic activity—no recovery—just general bottom-bouncing. Accordingly, real retail sales levels in the months ahead should become increasingly negative (see the household and disposable income comments in *Commentary No. 394* and *Commentary No. 398*).

***Real Money Supply M3.*** The signal of the unfolding double-dip recession, based on annual contraction in the real (inflation-adjusted) broad money supply (M3), discussed in the *Hyperinflation Special Report (2011)*, continues and is graphed above. Based on the October CPI-U report and the latest October SGS-Ongoing M3 Estimate, the annual contraction in real M3 for October 2011 was 0.9%, narrower than the revised 1.3% (previously 1.2%) annual contraction in September. The smaller annual contraction was due entirely to what should prove to be a short-lived downside blip in the annual CPI-U inflation rate.




The signal for a downturn or an intensified downturn is generated when annual growth in real M3 first turns negative in a given cycle; the signal is not dependent on the depth of the downturn or its duration. The current downturn signal was generated in December 2009. The broad economy tends to follow in downturn or renewed deterioration roughly six-to-nine months after the signal. Weakness in a number of series have surfaced in recent months, and the downturn likely will accelerate in the months ahead, eventually leading to recognition of a double-dip recession.

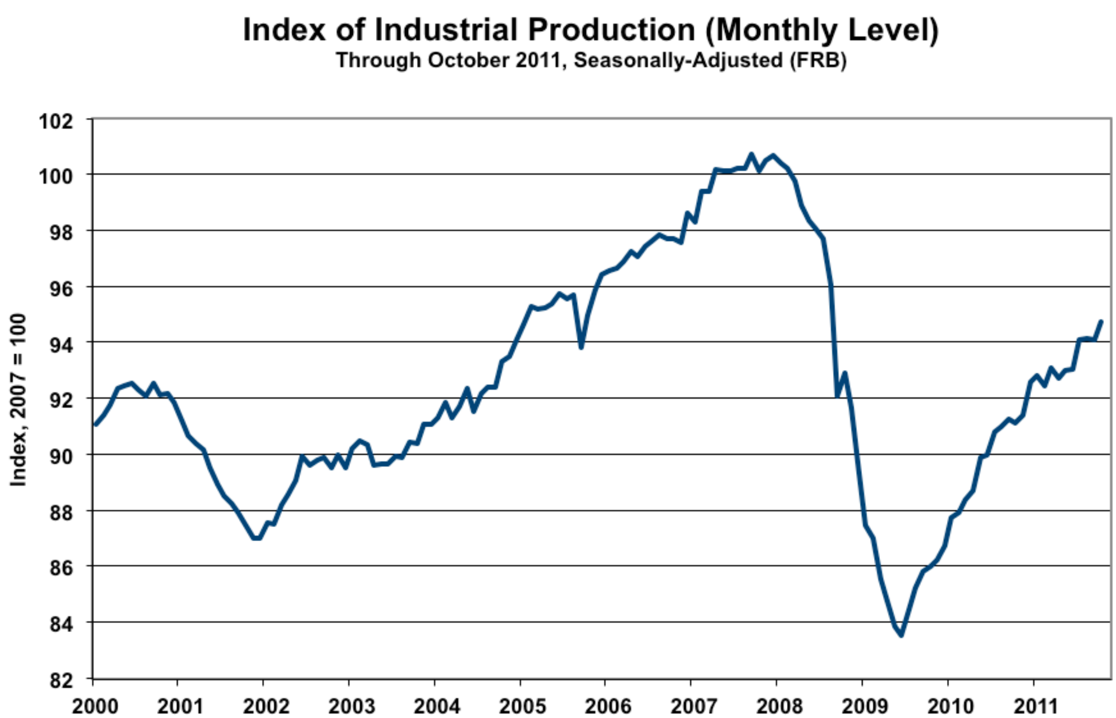
**INDEX OF INDUSTRIAL PRODUCTION (October 2011)**

**Industrial Production Gained in October Despite Revisions; September Production Revised to Contraction.** In the context of the usual six months worth of revisions, today's (November 16th) Federal Reserve Board release of seasonally-adjusted October 2011 industrial production showed a monthly gain of 0.68% (up 0.56% net of prior-period revisions) versus September. In turn, what had been a 0.19% gain in September revised to a 0.06% contraction.

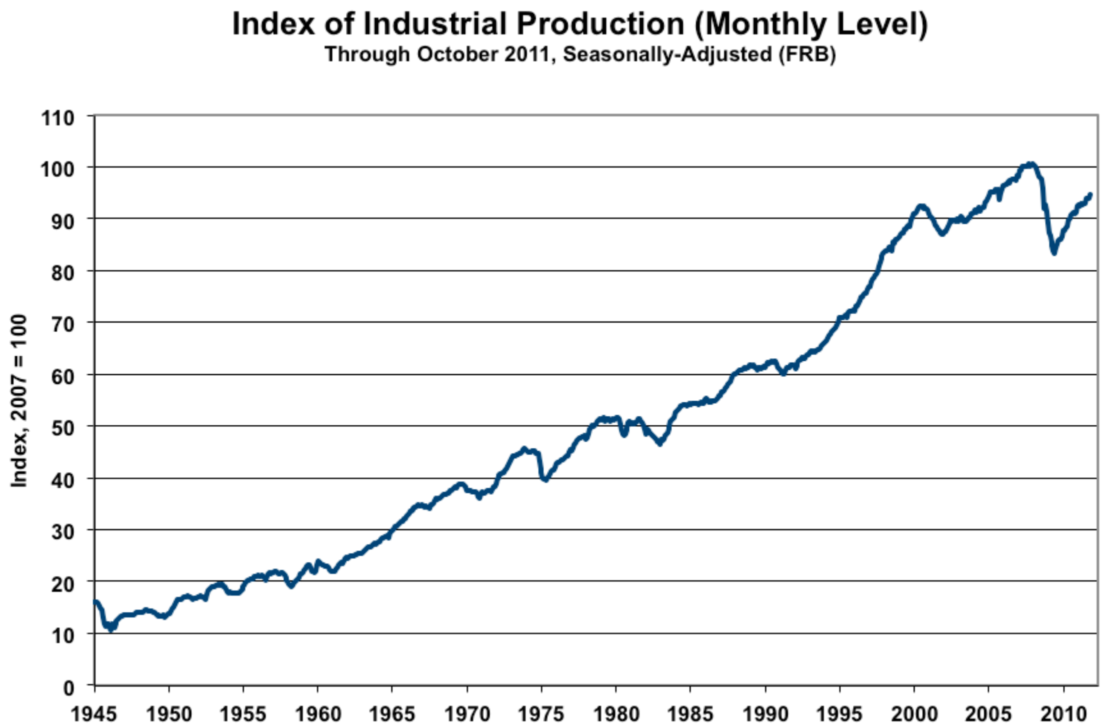
Year-to-year growth in October 2011 production was 3.92%, up from a revised 3.10% (previously 3.22%) September increase, and down from the recent relative peak annual growth of 7.75% in June 2010. The year-to-year contraction of 14.83% seen in June 2009, at the end of second-quarter 2009, was the steepest annual decline in production growth since the shutdown of war-time production following World War II.

The "recovery" in industrial production is reflected in the following graphs. Both graphs show the monthly level of the production index. The first of these shows close historical detail for the period beginning in 2000, the second shows the same data in historical context since World War II.

Keep in mind that as with real retail sales and the GDP, a portion of industrial production (largely high tech, such as computers) is estimated by deflating nominal (not adjusted for inflation) numbers with an inflation measure of nature similar to those used in the GDP estimates. Where those inflation estimates are understated, the resulting inflation-adjusted growth is overstated. These issues will be addressed in tomorrow's (November 17th) *Special Commentary—Underlying Economic Reality*.






**Week Ahead.** Although still not widely recognized, there is both an intensifying double-dip recession and an escalating inflation problem. Until such time as financial-market expectations catch up with underlying reality, reporting generally will continue to show higher-than-expected inflation and weaker-than-expected economic results in the month and months ahead. Increasingly, previously unreported economic weakness should show up in prior-period revisions.

***Residential Construction (October 2011).*** October housing starts are due for release tomorrow, Thursday, November 17th, and should show a continued downside bottom-bouncing trend. Any upside surprise likely would not be statistically meaningful.

__________