No. 485: SPECIAL COMMENTARY
Review of Economic, Systemic-Solvency, Inflation, U.S. Dollar and Gold Circumstances

November 27, 2012

Hyperinflation by End of 2014
Heavy Global Selling of U.S. Dollar Could Hit With Little Warning
Don’t Blame Intensifying Economic Downturn on Sandy or the “Fiscal Cliff”
Physical Gold Remains the Ultimate Hedge

PLEASE NOTE: This Special Commentary updates the outlooks for the U.S. economy and inflation, domestic fiscal stability and systemic liquidity, and the U.S. dollar and precious metals. It supplements Hyperinflation 2012 of January 25, 2012, which remains the primary www.ShadowStats.com document detailing the hyperinflationary threat in the United States, and it also builds upon Special Commentary No. 445 of June 12, 2012, and the intervening Commentaries that otherwise have updated the major economic and systemic-liquidity issues. Where some of the text here was in the preview included in Commentary No. 484, the bulk of that text has been rewritten or expanded in the material that follows.

Best wishes to all — John Williams
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U.S. ECONOMIC, SYSTEMIC-STABILITY AND INFLATION UPDATE

OVERVIEW – OPENING COMMENTS

Do or Die, Incoming Government Is Last Frail Hope for Avoiding
U.S. Dollar Collapse and Hyperinflation

Barreling Down the Road, Big-Government Spending
Tries Careening Around the “Fiscal-Cliff” Pothole, Looking Next to
Accelerate, Blithely Ignoring the “Road-Closed” Sign Ahead

Economy Already in Renewed Contraction

Set by Uncontained Fiscal Malfeasance, and Exacerbated by Still-Unfolding Effects of the 2008
Systemic Panic and Near-Collapse, U.S. Hyperinflation Looms by End of 2014. After decades of
U.S. government fiscal mismanagement, by 2004, the U.S. budget deficit was so out of control that it had
become both unsustainable and uncontainable. Using generally accepted accounting principles (GAAP-
accounting), the deficit for just the fiscal-year 2004 exploded to $11.0 trillion (versus a headline $412
billion gimmicked, cash-basis deficit), reflecting, among other items, severe impact from the overhaul of
the Medicare system.

Adjusted for distortions from one-time accounting changes, the actual, or GAAP-based, federal deficit has
run roughly $5 trillion per year since 2004, and it likely topped $7 trillion in 2012, with total federal debt
and the net present value of federal-government obligations approaching $90 trillion (see Table I in
Section III). No amount of spending cuts, outside of the politically-untouchable social programs, and no
amount of tax increases, can bring the GAAP-based annual U.S. budget deficit into balance.

As a result, by 2004, the United States had been doomed to hyperinflation by 2018, where the U.S.
government would have no practical choice but to meet its obligations by printing the money it needed.
Under such conditions, the U.S. dollar would suffer rapid debasement and inflation—undergoing an
actual hyperinflation—so as to become worthless, reflecting a full loss of its purchasing power. In 2005, I
expressed my concern for an eventual U.S. hyperinflation to a member of the Bush Administration, and
was told simply, “That’s too far in the future to worry about.” In fairness, the responsibility for the severe
mismanagement of the government’s finances and looming fiscal cataclysm can be laid on both sides of
the aisle, going back a number of administrations.

The U.S. financial and political system had been running amuck for decades, with the government and
consumers living well beyond their means, supported by excessive and unsustainable growth in debt.
Faced with structural impairments to individual income growth (see Section II on consumer liquidity), the
Federal Reserve (under Chairman Alan Greenspan) actively encouraged the excessive growth of consumer debt as a way to support economic activity, continuously borrowing economic growth from the future. Again, the federal government handled its own finances in like manner.

With an inevitable day of reckoning, the U.S. financial and banking systems came literally to the brink of collapse in September 2008. To prevent the unthinkable, the Federal Reserve and the U.S. government created, spent, loaned, guaranteed, and gave away whatever money was necessary, and otherwise bailed out or acquired a number of failing large corporations, including a number of banks, AIG, GM and Chrysler. Anything needed to keep the system afloat was pursued, whatever the cost.

Those actions forestalled a systemic collapse, but they did not resolve the fundamental underlying difficulties. An economic downturn—in place at the time—exacerbated systemic stresses. In turn, the financial panic and related government and Federal Reserve reactions pushed the recession into economic collapse. Contrary to official GDP reporting, there has been no subsequent economic recovery. Since the unofficial beginning of the economic downturn in early-2006, and the plunge in activity from 2008 into mid-2009, broad business activity simply has stagnated at a low level. There remains no recovery visible on the forecast horizon (see Section I on economic conditions).

Worse, the economic and systemic-solvency crises not only continue, but also now are deteriorating anew. Further, new business disruptions and systemic risks lie ahead. The ultimate costs for saving the system in 2008 and beyond, comes down to inflation, which will be reflected eventually in the complete debasement of the U.S. dollar. Accordingly, actions taken during the crisis-containment of 2008, and later, brought the outside timing for the hyperinflation forecast of 2018, into 2014. With 2013 little more than a month away, time has run out to avoid the ultimate financial crisis in the demise of the U.S. dollar.

From the onset of the economic downturn in 2006, through the eventual collapse of the dollar and its attendant constraints on economic activity, the unfolding financial-system crises eventually will exceed the depth and duration of the economic turmoil, and the disruptions to people’s lives, seen during the Great Depression of the 1930s.

These issues have been detailed in *Hyperinflation 2012*, which remains the base document for the hyperinflation outlook discussed here. While the broad outlook has not changed, the system has kept moving along the path to the hyperinflation, hence this update

**No More Kicking the Can Down the Proverbial Road (see Section III on Fiscal Conditions).**

President Barack Obama, in his second term, and the U.S. Congress to be seated on January 3, 2013 are the last and only (albeit negligible) hope for preventing severe economic, financial and social disruption in the United States within the next two years. A hyperinflationary great depression should be in the works by the end of 2014, where extreme disruptions to the normal flow of commerce, from the hyperinflation, would push the economy into a great depression (a peak-to-trough contraction in excess of 25% as described in the hyperinflation report).

With longer-range U.S. sovereign-solvency risks unaltered—actually deteriorating (see detail in Section III)—the U.S. dollar, as we know it, is not likely to survive until the next congressional election in 2014, let alone the next presidential election in 2016. The circumstance now for the U.S. government simply is to do or die.
In order to prevent the existing broad loss of global market confidence in the U.S. dollar from evolving into a hyperinflationary collapse of the U.S. currency, the federal budget needs to be balanced, not just in terms of the cash-based and gimmicked deficit reporting that showed a $1.1 trillion annual operating shortfall in 2012, but also, more importantly, in terms of GAAP-based accounting that likely showed a $7.0-plus trillion annual operating shortfall in 2012. As discussed in No. 481: Alert, however, the U.S. Treasury—in a post-election move—delayed publication of the 2012 GAAP-based financial statements of the U.S. government from the statutory December 15, 2012 to January 17, 2013. That means the latest GAAP numbers will not be available to Congress in the current “fiscal-cliff” and debt-ceiling negotiations. January 17th also leaves just one working day in the current presidential term, and for any cabinet members who may be leaving.

Even with better information available, though, the odds of the outgoing or the incoming (largely re-elected) political establishment taking the actions necessary to bring the U.S. fiscal system into balance are nil. The lack of adequate response here is due to the extreme economic pain that would follow such moves, and the related lack of political will to take actions that would dampen economic activity or touch the government’s social programs.

**Balancing the Budget, Social Programs and “Entitlements.”** Regardless of how much general government spending is cut or taxes are raised, there just is not enough other spending to cut, or other possible taxes to raise, that could eliminate the GAAP-based budget deficit, without there also being a major restructuring of programs such as Social Security and Medicare, so that they become solvent in the long-term. These are programs into which individuals have paid their money with expectations of future personal benefit, and some justifiably take offense at politicians referring to these programs as “entitlements.” Accordingly the term of “social programs” generally is used here to describe those elements of the federal budget.

The political miscreants, in that former malarial swamp on the Potomac, used the otherwise dedicated tax funds received on social programs for general spending. Where the Treasury has issued offsetting securities to the trust funds for the cash received, the government considers those funds as owed to itself, rather than to the public, as indicated in the U.S. Treasury’s GAAP-based financial statements.

Thanks to the Lyndon Johnson Administration, the once-cash-surplus of Social Security tax receipts over benefit payments has been used in gimmicked accounting to mislead the general public as to the size of the annual cash-based deficit. Yet, all has not gone as planned, recently. Hammered by the recent severe economic downturn, the Social Security annual cash flow turned negative in 2010, where it had been expected to show annual surpluses into 2017. In fiscal-year 2012, Social Security tax receipts of $488.8 billion fell shy of covering the $627.2 billion in benefits paid out by $138.4 billion.

Over the longer-term, the social programs are bankrupt, with the unfunded liabilities increasing each year by trillions of dollars. That is on a net-present-value (NPV) basis, which indicates the amount of funds needed in hand to cover the future cash outflow, adjusted for the time-value of money. In particular, as touched upon in the opening paragraph, Medicare was doomed to bankruptcy in 2004, with the enactment of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (enacted in December 2003, fiscal 2004). Put into perspective, the added $8 trillion (NPV) in 2004 of unfunded Medicare-related liabilities was then about the size of the total gross federal debt of the United States.
In order to balance the GAAP-based deficit, the social programs have to be restructured so as to be solvent in the long-haul. Again, there simply are not enough taxes that can be raised, or enough spending that can be cut otherwise, that would balance the actual, GAAP-based budget numbers. Also, particularly in a structurally-impaired economy, there is no chance of generating enough new economic activity to grow out of the deficit. Instead, meaningful deficit cutting now means taking a hit on economic activity. Such is the price and the catch-up for a nation that has been living beyond its means for decades.

“Fiscal Cliff” Is A Relatively Minor Issue. If left intact, the components of the “fiscal cliff” would reduce economic activity. They also would reduce the budget deficit some, but not meaningfully. The heavily massaged ten-year deficit projections used by the government are dependent on the underlying economic assumptions used in forecasting the spending shortfalls. The Congressional Budget Office (CBO) predicts a recession in 2013, if the “fiscal cliff” is not removed, but, at the same time, it still shows 4.7% booming GDP growth by 2015 in its underlying assumptions. Annual GDP growth has not been above 4.0% since the 1990s, and, as discussed below and in Section I on the economic conditions, what should become recognized as a new, official recession already has started.

The stronger the GDP growth assumptions used by those modeling the deficit numbers, the greater will be the estimated deficit reduction. Where the economy actually is weaker than consensus expectations, or overly-positive government assumptions, federal deficits will be worse than projected, and U.S. Treasury funding needs will be greater than expected.

Beyond that, the deficit numbers involved in the current negotiation process are not meaningful in the context of the annual GAAP-based deficits of $5 trillion or more. The big problem simply is not being considered or discussed seriously.

“Fiscal Cliff” and the Dollar. With the budget negotiations not covering the big problems, talk of really cutting or balancing the federal deficit “this time,” is little more than the usual political hype, pabulum for the domestic markets. Yet, global and domestic investors, who have been holding U.S. dollars and Treasuries since at least the panic of 2008, are running thin on patience. The economic and systemic-solvency crises of the last five years continue; the U.S. government has not shown any meaningful willingness to address, let alone to recognize its long-range solvency problems; and the Federal Reserve has set up a system for monetizing U.S. Treasury debt at will, so as to be able to handle ongoing banking-system solvency issues and to handle upcoming problems with U.S. Treasury auctions.

As an aside, the Fed has claimed that the purpose of its monetization program is to reduce the unemployment rate. There is nothing the Fed can do to boost the economy, or to reduce the unemployment rate, at present: it simply is using the weak economy as political cover for setting up its monetization machinery (see Section IV on systemic liquidity and the Federal Reserve).

If current “fiscal cliff” and debt-ceiling negotiations turn as negative as they did in 2011, that event could provide the trigger for a major sell-off in the dollar. If the negotiations go well, as currently is being hyped, then movement toward dollar deterioration still should begin to accelerate, post-agreement, as underlying the reality gains broad recognition in the markets. Very simply, any package put together now, as was the case in 2011, will not address the deficit problem meaningfully, irrespective of the hype that is put forth to the public.
The rest of the world demonstrated its willingness to dump the dollar, following the budget-deficit negotiations fiasco of July/August 2011. The stage now is set for a full dollar panic. With central banks having reduced their relative dollar-reserve holdings in recent years, the U.S. dollar likely will lose its global currency reserve status, as the crisis intensifies. Contentious or failed negotiations surrounding "fiscal cliff" or the debt ceiling easily could trigger panicked selling of the U.S. currency (see Section V on inflation, hyperinflation, U.S. dollar and gold).

Official Economic Activity Has Started to Turn Down Anew (see Section I on Economic Conditions). Some on Wall Street and in the government contend that the currently-planned "fiscal cliff" spending cuts and tax increases would push the U.S. economy into a new recession. Those claims may be aimed partially at setting up a scapegoat, where a renewed downturn already is underway.

The official second-dip of a double-dip recession likely will be timed from third-quarter 2012, in line with recent reporting of official real retail sales, industrial production and new orders for durable goods. Hurricane Sandy and the "fiscal cliff" may exacerbate early weakness in the intensifying downturn, but neither circumstance will have caused the new recession.

Negative GDP effects from Hurricane Sandy, in terms of business disruption, will be seen primarily in fourth-quarter 2012 GDP, but those downside effects will be offset at least partially by early rebuilding of damaged structures and the replacement of lost automobiles, furnishings, etc. Those same consumption factors, however, also should add some net upside activity to first-quarter 2013 GDP. Readers might find of interest the extraordinary photograph of a street in Hoboken, New Jersey, taken during the hurricane (Image A) in Section I.

Also, as shown in Section I, the reality remains that the economy never recovered from its collapse—from early 2006 into mid-2009—but rather it stagnated at a low level of activity from 2009 into 2012, and now it has started to decline anew. As was discussed in the hyperinflation report, the official recovery has been no more than a statistical illusion created by the government’s use of understated inflation in deflating the GDP, which results in an overstatement of the deflated economic growth.

Structural Consumer Liquidity Problems Continue to Mount, Impairing Broad Economic Activity (see Section II on Consumer Liquidity). Consumer liquidity remains severely impaired, and that is preventing sustainable growth in real (inflation-adjusted) consumption. As income conditions continue to deteriorate for many consumers, and as stagnation continues in consumer credit outstanding and consumer confidence, the level of real consumption has resumed its decline. With households in a severe and deteriorating liquidity squeeze, there has been no fundamental reason for an economic recovery and there is no recovery pending.

Federal Reserve Has Set Up the Machinery for Fueling Hyperinflation (See Section IV on Systemic Liquidity and the Fed). In combination with money supply growth still impaired versus extreme "easing" by the Federal Reserve; with commercial and consumer lending not growing; and with signals of increasing nervousness among bank depositors; the Fed’s announcement of QE3 in September 2012 was a strong indication of an ongoing and deteriorating bank-solvency crisis. The quantitative-easing actions by the Fed are intended to provide liquidity to, and to help maintain the solvency of the banking system.
Nonetheless, the Fed uses the ongoing economic weakness seen by the public as political cover for its easing actions, particularly as those efforts relate to helping politically-unpopular big banks.

As set up, QE3 formally enables the Federal Reserve to purchase and monetize U.S. Treasury debt at will, although there was nothing in place to prevent such actions before QE3. With QE2, the Fed effectively purchased and monetized the net issuance of the U.S. Treasury for a number of months, monetizing enough debt to trigger some money supply growth, weakness in the U.S. dollar, higher oil prices and higher consumer inflation.

When the Treasury borrows money from the public, the borrowed money comes from checking accounts held by the public. With offsetting checks or payments then made back to the public by the Treasury, there is an effective wash in terms of money creation. When the money is borrowed from the Fed, however, directly or through the banking system, the borrowed money effectively is new and without offset in the public bank accounts, so the total money in the system increases as the Treasury payments are made to the public, hence the term “monetization.”

As the dollar comes under heavy selling pressure, and as domestic and global investors increasingly shun U.S. Treasuries, the Fed’s monetization of Treasuries likely will be used to keep the Treasury market liquid, also helping to fuel what then will be a nascent hyperinflation.

Gold Remains the Primary Hedge Against the Oncoming Dollar Crisis (See Section V on Inflation, Hyperinflation, U.S. Dollar, Gold). Where there is little politically-feasible action the federal government or the Federal Reserve can take, so as to avoid a hyperinflation, there is much an individual can do to protect the purchasing power of his or her assets. Those options are discussed more fully in Hyperinflation 2012, and they remain unchanged. Holdings of physical gold and silver, as well as assets in the stronger Western currencies such as the Canadian and Australian Dollars and the Swiss franc should act as stores of wealth through the difficult times ahead. With core assets and wealth hedged with liquid hard assets, longer-term hedges (considered longer-term, due to possible short-term liquidity issues) are available with assets such as real estate and gold mining stocks.

Hyperinflation Odds. A subscriber suggested recently that I estimate odds for the hyperinflation forecast coming to pass. Accordingly, I assess the chances of a U.S. hyperinflation being underway by the end of 2014 at more than 90%, by the end of 2013 at more than 40%. A likely trigger event here, again, would be panic selling of the U.S. dollar and dumping of dollar-denominated paper assets such as U.S. Treasuries. The initial trigger event could be seen literally at any time. As the dollar crisis unfolds, government reactions with controls on capital flows and/or direct currency-market intervention would be likely and could buy a little time, but the ultimate demise of the dollar also would have been locked in at the same time (see Section V on inflation, hyperinflation, U.S. dollar and gold).
Section I — ECONOMIC CONDITIONS

Full-Recovery in Official GDP Still Has Not Been Confirmed by Any Other Major Economic Series. Official GDP reporting shows plunging economic activity from fourth-quarter 2007 into second-quarter 2009, with an ensuing upturn in activity that led to a formal full-recovery in the GDP, as of fourth-quarter 2011, when the level of real (inflation-adjusted) GDP activity first exceeded the pre-recession high in activity. That “recovery,” as shown in Graph 1: Headline Real GDP, has continued through third-quarter 2012 GDP reporting.

With the completion now of four quarters of expanding full-recovery in the GDP, there still is no other major U.S. economic series that has shown a similar pattern of full-recovery. That throws the official GDP reporting patterns into serious question.

Graph 1: Headline Real GDP

Headline Real GDP (Quarterly Index Level)
Nominal GDP Deflated by Official Implicit Price Deflator
To 3q2012, Seasonally-Adjusted (ShadowStats.com, BEA)

In contrast to the headline GDP reporting—and in line with patterns seen in better-quality economic series—I contend that the economy began turning down in 2006, plunging in 2008 into mid-2009 and subsequently stagnating—bottom-bouncing—at a low level of activity, ever since. There has been no
recovery since mid-2009, yet the economic downturn now is intensifying again, as seen in the current reporting of major series, such as real retail sales, industrial production and new orders for durable goods.

Even Federal Reserve Chairman Ben Bernanke recently observed that broad aggregate measures of the U.S. economy, such as the GDP, do not appear to be reflecting the common experience of the general public. Indeed, common experience suggests that the economy has not recovered. The official recovery simply is a statistical illusion created by the government’s use of understated inflation in deflating the GDP, which overstates the resulting inflation-adjusted GDP activity.

As discussed in Hyperinflation 2012, the underestimation of inflation used in deflating various economic series is a major systemic-reporting problem (also see Public Comment on Inflation), again with the resulting overstatement of the inflation-adjusted numbers and related growth rates. Updated from the referenced hyperinflation report, the following graphs represent official reporting, or they have been corrected—at least partially—for inflation underestimation.

Also included or referenced are graphs of economic series that have no relationship to inflation adjustment. They all show an economic pattern in recent years of business activity plunging from 2006/2007 into 2009, followed by a period of low-level stagnation or limited upturn, up to the present, no recovery as otherwise indicated by the official GDP accounting. As seen in the related Section II on consumer liquidity, the consumer’s liquidity conditions also are deteriorating, signaling intensifying economic difficulties ahead.

Where Graph 1 shows the official GDP reporting, Graph 2: Corrected Real GDP, immediately above, shows the same series, to the same scale, in a corrected version that removes the effects of an estimated two-percentage points of annual growth spiked by hedonic adjustments to GDP inflation. In general, the computer-modeled hedonic adjustments reflect lowered inflation estimates, adjusting for nebulous hedonic quality improvements. The estimation and graph here are simple approximations, but they show
the significant impact of changes in assumed inflation. The inflation-adjusted estimate here is not the same as the SGS-Alternate GDP measure, which involves significantly greater and varied adjustments and is not estimated on a seasonally-adjusted quarterly basis.

The corrected real GDP series shows stagnation since mid-2009, no pattern of recovery, somewhat similar to the pattern of reported nonfarm payroll employment levels seen in Graph 3. Graphs 1, 2 and 3 all are plotted to the same scale. While the relationship between employment and GDP is not one-to-one, the payroll series—which has no inflation adjustment imbedded in its reporting—shows a pattern of activity that is much more consistent with the corrected GDP than with the headline GDP.

**Graph 3: Nonfarm Payroll Employment**

![Nonfarm Payroll Employment (Monthly Index Level)
To Oct 2012, Seasonally-Adjusted (ShadowStats.com, BLS)](image)

**Graph 4: Unemployment Rate**

![Unemployment Rate - Official (U-3 & U-6) vs SGS Alternate
Monthly SA. Through Oct. 2012 (SGS, BLS)](image)
A lack of economic recovery also is evident when viewing the broader measures of unemployment seen in Graph 4 (see Commentary No. 479 for background detail on those series), or when viewing levels of activity in housing starts (Graph 5). The plunge-and-bottom-bouncing economic series all tend to lack any inflation-adjusted factors, including the payroll, unemployment and housing starts numbers just discussed, and including the graphs of consumer sentiment and consumer confidence (Graphs 16 and 17) seen in Section II — Consumer Liquidity. Also in Section II, Graphs 11, 12 and 14 on various income measures, even though deflated by the CPI-U, confirm the lack of a post-2009 economic recovery.

**Graph 5: Housing Starts**

Housing Starts (Monthly Index Level)
To Oct 2012, Seasonally-Adjusted (ShadowStats.com, Census)

The major series not confirming a full GDP recovery, but still having had a good bounce-back in activity, include only real retail sales and industrial production (Graphs 6 and 8). Significantly, both of those series now also show official, renewed downturn. What they have in common with the GDP measure is a reliance on inflation-adjustment. When corrected for flawed deflation, using the ShadowStats.com’s SGS Alternate Consumer Inflation Measure (1990-Base) versus the CPI-U, the retail sales pattern shown in Graph 7: Corrected Real Retail Sales becomes one of plunge and stagnation, as seen in the other non-inflation-based or corrected series. The corrected real retail sales graph also shows a pattern of activity that is more consistent with all the income, confidence and credit graphs shown in Section II.

**Graph 9: Corrected Industrial Production** has minor adjustment for poor-quality deflation, reflecting the removal of the effects of hedonic inflation adjustments on affected production components. While there
remains some weakened upturn in the series, production levels remain well below those seen going into the 2001 recession, and certainly show no full-recovery in the current circumstance.

**Graph 6: Real Retail Sales (CPI-U Deflator)**

**Real Retail Sales (Deflated by CPI-U)**
To Oct 2012, Seasonally-Adjusted (ShadowStats.com, Census)

**Graph 7: Corrected Real Retail Sales (SGS-Alternate Deflated)**

**Corrected Real Retail Sales**
Deflated by SGS-Alternate CPI (1990-Base)
To Oct 2012, Seasonally-Adjusted (ShadowStats.com, Census)
Graph 8: Industrial Production

Industrial Production
To Oct 2012, Seasonally-Adjusted (ShadowStats.com, FRB)

Graph 9: Corrected Industrial Production

Corrected Industrial Production
Inflation Understatement from Hedonic Adjustments Removed
To Oct 2012, Seasonally-Adjusted (ShadowStats.com, FRB)
Graph 10: Real New Orders for Durable Goods, though deflated by inflation indicated in the PPI capital goods measure, has not been corrected for hedonic adjustments. Yet, it still shows a post-economic collapse pattern similar to that of the corrected industrial production. It also has started to turn down anew. The six-month moving average in durable goods order activity remains below the level seen going into the 2001 recession, and it remains well below a full-recovery in the current circumstance.

The Broad U.S. Economy Is in Ongoing Recession/Depression. The graphs here and in the next section suggest that there has been no recovery in economic activity, since the economy plunged from 2006/2007 into mid-2009, just ongoing low-level stagnation. Reporting of retail sales, production and durable goods orders shows the economy turning down, once again, into what will become recognized as the second-dip of a double-dip recession, likely timed from third-quarter 2012. The reality remains that current economic woes are an ongoing part of protracted economic collapse, not the beginning of a new cycle. That circumstance is confirmed repeatedly by the data in Section II — Consumer Liquidity, where the underlying consumer-liquidity fundamentals drive broad economic activity.

While the current downturn remains the most severe of the post-Great Depression Era, with no indications of near-term relief, occasionally there are temporary bumps and drops in economic activity caused by exogenous factors, such as natural disasters like Hurricane Sandy.
Temporary Economic Boost From Disaster Effects, But No Recovery. In terms of GDP reporting, disruptions to business activity and to the normal flow of commerce reduce estimated economic growth. Otherwise, property damage from any disaster, natural or man-made, does not affect the GDP estimates, directly. Rebuilding activities resulting from a disaster, however, usually are reported as economic gains.

Accordingly, eventual positive impact on the economy from the hurricane a.k.a. Superstorm Sandy—which devastated parts of the East Coast in the last three days of October—will be seen in the rebuilding of homes and businesses and the replacement of destroyed furnishings, automobiles, etc.

Image A: Helpful Auto Industry Planning versus Hurricane Sandy

When Hurricane Sandy made landfall in central New Jersey, south of New York City, on October 29th, the city of Hoboken—located across the Hudson River from Manhattan—began to flood. Recent technological advancement in the auto industry has included efforts to help save people who have driven into bodies of water, off a bridge or road into a river or lake, for example. As the Hoboken floodwaters rose, parked cars lining the streets duly signaled their underwater locations with lights on and with car alarms blaring, and they automatically opened all windows to allow trapped passengers to escape. Unfortunately, for car owners trying to close windows, so as to minimize damage to their automobile’s interior, or otherwise trying to sleep through the cacophony of hundreds of car alarms calling for help, there was no hope.
Replacement of a large number of damaged automobiles—both individual and fleet owned—should provide the U.S. auto industry with a brief respite from otherwise disappointing sales activity.

The boosts provided to housing and business construction, to sales of related furnishings and supplies, automobiles, etc. will be funded out of the consumer’s pocket, from private insurance, from federal flood insurance or from other federal or local funding programs. Those activity gains, however, will be short-lived. Without an accompanying meaningful and sustained positive change to underlying consumer liquidity, and such a change in consumer liquidity is not underway, there can be no sustainable economic recovery.

Negative economic impact from storm-related business disruption will be part of fourth-quarter 2012 GDP, with some positive offset from initial recovery activities. Largely positive net impact from recovery activities should be a factor in first-quarter 2013 GDP, with waning effects in subsequent quarters.
Section II — CONSUMER LIQUIDITY

There Can Be No Sustainable U.S. Economic Recovery, Without Sustainable Real Growth in Consumer Income. From day one, the current economic collapse was driven by long-term structural problems that had constrained real (inflation-adjusted) growth in consumer income. For more than four decades, income losses were tied closely to higher-paying production jobs being lost to offshore competition.

As a result, households increasingly needed more than one breadwinner in order to make ends meet. Even so, household income growth generally was unable to keep up with inflation, and households increasingly took on debt to offset the shortfall in their living standards. Alan Greenspan’s Federal Reserve actively encouraged such debt accumulation in order to support what otherwise rapidly would become foundering economic activity.

Following the 2008 panic, consumer liquidity took a severe hit, when easy credit dried up. Lacking real income growth and credit availability, and nervous about future economic stability, consumers cut back sharply on spending, intensifying an economic downturn that had been underway since early-2006. With similar concerns, commercial ventures cut back as well.

Graph 11: Real Median Household Income - Monthly

Real Median Household Income Index (Monthly Level)
To Oct 2012, Seasonally-Adjusted (www.SentierResearch.com)
**No Economic Recovery Reflected in Real Income Series.** As shown in *Graph 11: Real Median Income – Monthly*, the median household income series, prepared monthly by [www.SentierResearch.com](http://www.SentierResearch.com), and just updated for October 2012, is deflated by the CPI-U. The numbers show that household income took its biggest hit in the formal post-recession period, and that current monthly levels are stagnating at the lowest level in more than a decade (allowing for the normal monthly volatility of the series).

Similar data on an annual basis, published by the Census Bureau in its most-recent *Poverty Report*, showed that real (deflated by the CPI-U) median household income in 2011 had dropped to levels last seen in the early-1990s and was at levels below those seen in the late-1960s. This is as discussed in *Commentary No. 469* and plotted in *Graph 12: Real Median Household Income – Annual*, below.

As plotted in *Graph 13: Annual Income Variance*, directly following, and as also discussed in *Commentary No. 469*, income variance hit a post-Great Depression record high in 2011. Generally, the higher that income variance is, the greater is the concentration of incomes in high- and low-income brackets, reflecting a squeeze on middle incomes. A high level of income variance usually is a leading indicator of economic difficulties in the years ahead. With only a minor downside corrective blip seen in the data around the 2007/2008 crisis and panic, and with neither economic nor systemic-solvency issues having been resolved by U.S. government or Federal Reserve actions, the 2011 readings on income variance suggest that the worst of the economic and systemic troubles are yet to be seen.
Graph 13: Annual Income Variance

Household Income Dispersion
Gini Index versus Mean Logarithmic Deviation
1967 to 2011 (Census Bureau, Poverty Report)

Graph 14: Real Median Usual Weekly Earnings

Real Median Usual Weekly Earnings
Full-Time Wage and Salary Workers
Quarterly Average to 3q2012, Deflated by CPI-U
Seasonally Adjusted (ShadowStats.com, BLS)

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As with the real median monthly household income series (Graph 11), real median usual weekly earnings (deflated by the CPI-U), as plotted quarterly in Graph 14, have been in decline since the formal economic recovery began, following second-quarter 2009, and allowing for CPI variations tied to volatile gasoline prices. As with the various economic series plotted in Section I, these indicators of consumer income suggest that no economic recovery has taken place, and that no recovery is underway.

Real average weekly earnings (officially deflated by the CPI-W), in Graph 15, have been in decline for four months and still are well below the peak level seen in the early-1970s. Deflated by the SGS-Alternate Consumer Inflation Measure (1990-Base), the series has been in relatively steady decline for decades, a pattern that is repeated in most of the income measures, using deflation by the SGS numbers.

With lack of positive, real growth in income, there can be no sustainable growth in real personal consumption. Temporary consumption gains could be fueled by debt expansion, but that option also is not available to most consumers. Consumer sentiment and confidence levels (Graphs 16 and 17) remain at low levels generally not seen historically outside of the depths prior recessions. Confidence affects willingness to borrow, but even with limited consumer willingness, the still financially-stressed banking system is not lending in a normal fashion.

As seen in Graph 18: Consumer Credit Outstanding, there still has been no growth in consumer credit, outside of the extraordinary growth in federal-government owned student loans. From the standpoint of consumer spending, consumer credit has been in decline or bottom-bouncing since the economic plunge.
**Graph 16: Consumer Sentiment**

**Consumer Sentiment -- University of Michigan**
To November 2012 (ShadowStats.com)

- 3-Month Moving Average
- Monthly Level

**Graph 17: Consumer Confidence**

**Consumer Confidence -- Conference Board**
To October 2012, Seasonally Adjusted (ShadowStats.com)

- 3-Month Moving Average
- Monthly Level
The discontinuity in the above graph is due to a sharp upside restatement to the level of credit, resulting from a redefined and expanded Fed survey, but earlier periods were not restated on a consistent basis. The growth patterns appear to have been unchanged. There just is a higher reported level of activity.

**Consumer Liquidity to Be Pummeled Anew by Taxes.** The U.S. consumer accounts directly for 71% of GDP activity with “personal consumption expenditures,” and indirectly for the bulk of the remaining 29% of economy. With consumer income and credit structurally impaired, real growth in consumer spending and the broad economy is not sustainable. Not only has the U.S. economy not recovered, as discussed in this and the previous section, but also the consumer’s ongoing liquidity problems indicate that there is no economic rebound pending in the immediate future. To the contrary, deepening income difficulties suggest strongly that near-term economic activity is headed lower.

The negative outlook is compounded by the prospects of higher taxes at the federal, as well as at some state levels. Taxes always are an economic depressant, not a stimulant. At certain levels of taxation, higher taxes actually increase budget deficits, rather than reduce them, because of decreasing revenues from the resultant declining economic activity and incomes. The system is at such a point. As an example, consider that with federal tax changes being discussed for upper-income individuals, and with the revamping of personal taxes in California, as result of the election, incremental take-home pay for Californians earning higher incomes could be reduced by 20% in the year ahead, with some of the new taxes also being retroactive. This circumstance likely will have negative impact on the both the affected economies and federal and state budget deficits.
Section III — FISCAL CONDITIONS

Graph 19: Gross Federal Debt versus GDP

Gross Federal Debt versus Nominal GDP
September 30th Fiscal Year through 2012
(ShadowStats.com, St. Louis Fed, U.S. Treasury, BEA)

GAAP-Based Accounting Shows Eventual U.S. Bankruptcy. Since 2002, the U.S. Treasury has been publishing audited financial statements of the U.S. government, using generally accepted accounting principles (GAAP). The graphs and tables in this section provide some background from the details of those statements. The general relationship of the GAAP numbers to the long-range U.S. solvency issues, as well as a discussion of the “fiscal cliff” negotiations, are covered in the Overview section.

*Table 1: U.S. Government GAAP Accounting, Deficits and Obligations,* at the end of this section, has been expanded to include two unaudited years of 2000 and 2001, the last years that the gimmicked, cash-based accounting reflected a surplus (GAAP accounting was in deficit), and where numbers reasonably consistent with the later, audited data were available. The table also includes my rough estimates for fiscal 2012 results, since the publication of those numbers has been delayed from the statutory December 15th, to January 17th. The estimate of a $7.0 trillion GAAP-based deficit in 2012 reflects deteriorating
economic conditions, some likely more realistic reporting on the liabilities tied to the Affordable Care Act (ACA), also known as Obamacare, and possible consolidation of troubled entities, such as Fannie Mae and Freddie Mac into the federal government’s numbers.

Graph 19: Gross Federal Debt versus GDP, at the opening of this section, plots the level of the government’s fiscal-year-end debt level, versus the average nominal (not adjusted for inflation) GDP level for the same fiscal-year ended September 30th. In 2012, the debt level overtook the nominal GDP.

In Graph 20, the same information is shown, but the government number reflects total federal obligations (including debt), as shown in Table 1. As of fiscal 2012, total obligations, which include the net-present-value of the unfunded liabilities for the government’s social programs, was pushing a ratio of six-to-one over the level of the GDP.

The final plot here is Graph 21: GAAP- versus Cash-Based Annual Federal Deficit, introduced at specific subscriber request. The annual GAAP numbers have been adjusted for one-time accounting changes that otherwise would distort consistent year-to-year GAAP-based numbers, as discussed in the footnotes of Table 1. Again, Table 1 follows at the end of this section.
Graph 21: Cash-versus GAAP-Based Annual Deficits

GAAP-versus Cash-Based Annual Federal Deficit
September 30th Fiscal Year through 2012
GAAP Is Adjusted for One-Time Accounting Changes
(ShadowStats.com, St. Louis Fed, U.S. Treasury)

Cash-Based

GAAP-Based

Trillions of Dollars

<table>
<thead>
<tr>
<th>(I) Fiscal Year(^{(1)})</th>
<th>(II) Formal Cash-Based Deficit [Surplus] ($Billions)</th>
<th>(III) GAAP Ex-SS Etc. Deficit [Surplus] ($Billions)</th>
<th>(IV) GAAP With SS Etc. Deficit [Surplus] ($Trillions)</th>
<th>(V) GAAP Federal Negative Net Worth ($Trillions)</th>
<th>(VI) Gross Federal Debt ($Trillions)</th>
<th>(VII) Total Federal Obligations (GAAP) ($Trillions)</th>
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<tr>
<td>2012</td>
<td>$1,089.2</td>
<td>n.a.</td>
<td>$7.0(^{(e)})</td>
<td>$80.5(^{(e)})</td>
<td>$16.1</td>
<td>$88.0(^{(e)})</td>
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<td><strong>GAO-Alternative(^{(3)})</strong></td>
<td></td>
<td></td>
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<td></td>
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<td></td>
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<tr>
<td>2011</td>
<td>$1,296.8</td>
<td>$1,312.6</td>
<td>$4.6(^{(5)})</td>
<td>$73.5</td>
<td>$14.9</td>
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<td>2,080.3</td>
<td>5.3(^{(3)})</td>
<td>68.9(^{(3)})</td>
<td>13.6</td>
<td>76.3(^{(3)})</td>
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<tr>
<td>2011</td>
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**Footnotes:** (n.a.) Not available.  (e) ShadowStats.com (SGS) estimate versus GAO alternative-2011 (see text).  (1) Fiscal year ended September 30th; the numbers are subject to rounding differences and to Treasury revisions.  (2) Includes gross federal debt, not just “public” debt.  While the non-public debt is debt the government owes to itself for Social Security, etc., the obligations there are counted as “funded” and as such are part of total government obligations.  (3) Fiscal years 2011 and 2010 are broken out into “Alternative” and “Official” measures necessitated by “Official” 2010 reporting including a large, one-time reduction in the estimated net present value of unfunded Medicare liabilities, due to unrealistically favorable assumptions tied to the passage of the Affordable Care Act (ACA) healthcare legislation.  With consistent accounting, SGS estimates the GAAP shortfall with Social Security and Medicare for 2010 to be roughly $5 trillion.  The “GAO-Alternative” numbers here are being used as a placeholder.
Sources for the ShadowStats.com (SGS) Table Data:

**Fiscal Year (Column I)** – All numbers are for the indicated fiscal-year (ended September 30th), in either billions or trillions of dollars as shown.

**Formal Cash-Based Deficit (Column II)** – headline deficit number from Table 3 on page 7 of the 2011 report, “Management’s Discussion and Analysis” (hereinafter referred to as MDA). Please note that the latest (November 2011) monthly statements from the U.S. Treasury show a 2011 deficit of $1,296.8 billion and a 2010 deficit of $1,294.2 billion.

**GAAP ex-SS Etc. Deficit (Column III)** – euphemistically referred to as “Net Operating Cost” in MDA (Table 3 on page 7). It excludes annual change social insurance unfunded liabilities.

**GAAP with SS Etc. Deficit (Column IV)** – previous number (Column III) plus year-to-year change in the net present value (NPV) of social insurance unfunded liabilities, which comes from MDA (Table 8 on page 21) line “Closed Group” under “Statement of Social Insurance,” 2011 minus 2010 (for the 2011 “Official” number). The “Closed Group” is used here for consistency, as it has been the preferred measure used by the U.S. government in its earlier statements. The “Official” closed group NPV for fiscal 2011 and 2010 respectively are $46,273 and $43,057 billion.

The “Alternative” accounting adds in the differential to the MDA line “Closed Group” and the $12.4 trillion additional net present value of excess expenditures over income for Medicare shown in the “Illustrative Alternative Scenario,” shown in the table on page 130 of the 2010 report (for the 2010 “Alternative” estimate), and the differential between the 2011 “Illustrative Alternative Scenario,” data on page 134 of the 2011 Report, and the 2010 data, to estimate the 2011 number. The resulting “Alternative” closed group NPV estimates for fiscal 2011 and 2010 respectively are $58,707 and $55,410 billion.

**GAAP Federal Negative Net Worth (Column V)** – “Net Position” from MDA Table 5 on page 11, plus the 2011 “Closed Group” “Official” and “Alternative” total net present value unfunded liabilities of social insurance as indicated and adjusted in Column IV.


**Total Federal Obligations (Column VII)** – “Total Liabilities” from the MDA Table 5 on page 11, in the 2011 report, plus the 2011 “Closed Group” “Official” and “Alternative” total net present value unfunded liabilities of social insurance as indicated and adjusted in Column IV, plus total intragovernmental debt of $4,710.9 billion from (p. 92) of the 2011 report.

The 2011 GAAP statements were released on December 26, 2011: [http://fms.treas.gov/fr/index.html](http://fms.treas.gov/fr/index.html). The release of the 2012 GAAP statements has been delayed until January 17, 2013.
Section IV — SYSTEMIC LIQUIDITY AND THE FED

The System Still Suffers from the 2008 Panic. The systemic-solvency crisis continues, and it appears to be intensifying, again, coincident with a renewed decline in key, official economic reporting. The U.S. banking system remains troubled and still is not lending to the public or into commerce in normal fashion.

The Fed’s introduction of QE3, in September 2012, set the stage for open-ended purchases by the U.S. central bank of mortgage-back securities, as well as U.S. Treasury securities, at the Fed’s discretion. The latter instruments also were targets of QE2. As suggested in Graphs 22 and 23 of the monetary base, however, QE3 has not had major impact on the Fed’s numbers, yet. The mechanism for eventual complete debasement of the dollar now is in place, though, and it likely will come into full play, as needed to support the banking system, and as needed to assure “successful” auctions of Treasury debt.

The monetary base includes currency in circulation and bank reserves, but only the currency component is included in the money supply numbers. The extraordinarily high level of excess reserves usually would flow into the money supply, with banks lending aggressively into the normal flow of commerce, but that has not happened.

With still-impaired balance sheets, the banking system is unable to lend money in a normal manner. The various easings by the Fed have been aimed at supporting the banking system, not at stimulating the economy. The Fed knows that there is little it can do to boost economic growth. It’s primary function remains to support the system, and it uses the weak economy as political cover, when it moves to help prop up the banks.

As discussed in the Overview – Opening Comments, the Fed’s purchases of U.S. Treasuries monetizes the federal debt, at least minimally boosting the money supply, as new cash provided by the Fed is sent out to the public. When the U.S. Treasury pays its bills, that cash is deposited into private bank accounts, and M3 increases, whether or not the banks increase their lending as result. The impact of QE2 is seen in the recent small increase in broad money supply growth (M3), as plotted in Graph 24. QE3 is an enabling action for the onset of massive inflation.

M3 Velocity Is on the Rise. Subscribers often ask about the velocity of money, which is discussed in some detail in the 2008 Money Supply Special Report. Velocity simply is the number of times the money supply turns over in the economy in a given year, or the ratio in nominal terms (not adjusted for inflation) of GDP to the money supply. At present, the velocity of M2 is falling, but the velocity of M3 (using the SGS Ongoing-M3 Measure) is rising, as shown in Graph 25: Velocity of M2 and M3.

Velocity has theoretical significance, where, in combination with money supply growth, it can be a driving force behind inflation. Yet, since velocity is the ratio of two numbers that are not particularly well or realistically measured, I do not put much weight in its actual estimate.
What remains of interest, though, is why M3 and M2 are showing opposite patterns. The difference is that the growth in M3 remains weaker than the growth in M2. The reason behind the difference largely is that much of the M2 growth in the last year has reflected cash moving out of M3 categories—such as large time deposits and institutional money funds—into M2 or M1 accounts. Again, M3 contains M2, and M2 contains M1. The effect of the funds shift has no impact on M3, but it spikes relative M2 growth. The clarity of what is happening here is why I like to follow the broadest money measure available.

**Systemic-Confidence Measure.** The declining M3 components are larger accounts that—at best—are only partially covered by government guarantees in normal times. Accordingly flight of cash from M3 to the M2 level can reflect lack of confidence in the banking system (other factors at play include interest rates). A similar indicator reflects the flight of various money measures into hard cash. A decline in the ratio indicates mounting stress.

As shown in **Graph 26: Systemic Confidence Ratio – M3 to M2**, and **Graph 27: Systemic Confidence Ratio – M3 to Currency**, the systemic stress measures have not recovered from the plunge that began with the 2008 panic. The ongoing nature of the decline appears indicative of continuing or mounting systemic stress, declining confidence, and well could be suggestive of why the Fed moved to introduce QE3.

**Lending and Borrowing Remain Abnormal, Likely Reflecting Banking-System Stress.** Based on the highly unstable and unreliable reporting of the latest flow-of-funds analysis, from the Federal Reserve, the largest growth in second-quarter 2012 borrowing was by the federal government. The Federal Reserve reports on the Treasury’s issuance of debt for public consumption, not gross federal debt, which includes such items as debt issued for the Treasury’s borrowings of Social Security tax receipts. Nonetheless, gross federal debt is shown in **Graph 19**, in the prior section (**Section III – Fiscal Conditions**). Bank lending, however, still is far from normal, a sign of ongoing systemic stress.

On the business front, the flow-of-funds accounting reflected continued, but slowing growth in corporate bond issuance, while bank lending in commercial and industrial loans (**Graph 28**) continued to rise. C&I loans, however, remained well off the pre-2008-panic peak, while the gains there have been more than offset by the continued decline in commercial paper outstanding (**Graph 29**).

As shown in **Section II — Consumer Liquidity**, **Graph 18: Consumer Credit Outstanding**, regular bank lending to consumers continues to bottom-bounce. The only growth that has been seen in consumer credit, since the pre-2008-panic peak, has been in student loans from the federal government.

**Fed Had No Choice But to Prevent Systemic Collapse, Even at the Cost of Hyperinflation.** The U.S. central bank has no way out. With the systemic-solvency crisis continuing, risk remains of another September 2008-like crisis. In 2008, the Fed and the central government moved jointly to prevent a systemic collapse, regardless of cost, and they most likely would do so again. Given the likely political impossibility of resolving the U.S. fiscal crisis, the steps taken in 2008 and since have doomed the U.S. to a near-term dollar-selling panic and eventual hyperinflation. The Fed does not want a hyperinflation, but the extraordinary short-term measures aimed at forestalling a 2008 systemic collapse were preferable to having an immediate collapse. The Fed’s ultimate responsibility is to keep the banking system afloat. Some time was bought, but that was all the Fed and the federal government accomplished. That time now is running out.
Graph 22: Monetary Base Level

St. Louis Fed Adjusted Monetary Base
Bi-Weekly through November 14, 2012, SA, St. Louis Fed

Graph 23: Year-to-Year Money Base Growth

St. Louis Fed Adjusted Monetary Base
Yr/Yr %, Bi-Weekly through Nov 14, 2012, SA, SGS, St. Louis Fed
Graph 24: Year-to-Year Money Supply Growth

Annual U.S. Money Supply Growth - SGS Continuation
Yr/Yr % Change by Month through Oct. 2012 (FRB, SGS)

- M3 Official
- M3 SGS
- M2
- M1

Published: Nov. 17, 2012

Graph 25: Velocity of M2 and M3

Velocities of M3 and M2 (1q1959 to 3q2012)
Nominal GDP/Nominal Money Supply
ShadowStats.com, FRB, BEA
Graph 26: Systemic Confidence Ratio – M3 to M2

Systemic Confidence Ratio (M3 to M2)
Through Nov 2012, Seasonally-Adjusted (ShadowStats.com, FRB)

Graph 27: Systemic Confidence Ratio – M3 to Currency

Systemic Confidence Ratio (M3 to Currency in Circulation)
Through Nov 2012, Seasonally-Adjusted (ShadowStats.com, FRB)
Graph 28: Commercial and Industrial Loans

Commercial & Industrial Loans (Monthly Level)
To Oct 2012, Seasonally-Adjusted (ShadowStats.com, FRB)

Graph 29: Commercial Paper Outstanding

Commercial Paper Outstanding (Monthly Level)
To Oct 2012, Seasonally-Adjusted (FRB)
Section V — INFLATION, HYPERINFLATION, U.S. DOLLAR AND GOLD

Hyperinflation Update—Timing Takes a More-Solid Form. I have been warning of a hyperinflation for at least seven years, but those warnings have been about a hyperinflation that was sometime in the future, generally in 2018 or 2014 timeframes mentioned in the Overview. With the passage of time, circumstances have continued to evolve that still indicate a U.S. hyperinflation by the end of 2014. Hyperinflation 2012 remains the primary document and reference here on the hyperinflation threat. As was discussed in that report, not only had the U.S. dollar lost its primary role as a safe-haven currency by the time of the “Arab Spring” in 2011, but also global confidence in the dollar appeared to collapse, following the budget-deficit and debt-ceiling negotiations fiasco later that year, in conjunction with the Fed’s earlier monetization of U.S. Treasury debt and a debt downgrade to U.S. Treasuries. Those latter elements remain in near-term play.

Hyperinflation Odds. As discussed in the Overview, I assess the chances of a U.S. hyperinflation being underway by the end of 2014 at more than 90%, by the end of 2013 at more than 40%. A likely trigger event here would be panic selling of the U.S. dollar and dumping of dollar-denominated paper assets such as U.S. Treasuries. The initial trigger event could be seen literally at any time, including the potential for unusually negative developments surrounding the government’s current fiscal and debt-limit negotiations.

As a significant dollar crisis unfolds, government responses—with controls on capital flows and/or direct currency-market intervention—would be likely, and that could buy a little time, but the damage to the U.S. financial system and to U.S. dollar credibility have been so severe in recent years that the ultimate demise of the dollar also would be locked in following such actions. Further, see the hyperinflation report for a discussion on how hyperinflation in the United States would be disruptive to the normal flow of domestic commerce, pushing the current near-depression circumstance into great-depression status.

Why 2014? While inflation is far from being out of control at the moment, the U.S. dollar has weakened in recent months in response to some easing of the euro crisis, and to mounting concerns over the U.S. fiscal problems. Fiscal, systemic-solvency and economic conditions are deteriorating markedly, with a confluence of unstable circumstances likely to come to a head within the next year, placing extremely heavy selling pressure on the U.S. dollar along with dumping of U.S. dollar-denominated paper assets, such as U.S. Treasuries, before 2014. Those circumstances effectively would lead to a full collapse of confidence in the dollar and the eventual hyperinflation.

Those unstable circumstances and issues related to them include, but certainly are not limited to:

- **Economic Deterioration.** The U.S. economy is far weaker than commonly viewed—it never recovered from the 2006/2007-to-2009 plunge in activity—and has begun to show renewed deterioration in terms of retail sales, production and new orders (see Section I). Official projections for the federal budget deficit, for U.S. Treasury funding needs and for the stability of the U.S. banking system under financial and economic stress, all are based on overly optimistic economic assumptions. Accordingly, unhappy surprises in these areas await the system.
• **Rapidly Deteriorating Budget Deficit.** Fundamental effects of the crises already have been seen in deteriorating funding conditions for Social Security and the annual budget deficit in general.

  o Coming into the economic and systemic crises, the cash-based federal budget deficit was running in the $200 to $300 billion range in 2005 and 2006, and the annual cash surplus then generated by Social Security—a regular annual prop to the aggregate cash-based results—was projected to continue until 2017 or 2018. Reflecting the impact of the recession, Social Security cash flows began turning negative in 2010, seven or eight years ahead of schedule (see Overview).

  o Also reflecting the effects of the recession and the crises responses of the Fed and federal government, the annual cash-based federal deficit exploded, hitting $1.0 trillion or above for each of the last four years, with annual GAAP-based deficits running at $5 trillion or more (see Section III).

  o Economic and political issues rapidly will expand the current federal budget deficit well beyond existing official projections or market expectations. In response, the global markets should turn on the U.S. dollar, with massive selling and dumping of dollar-denominated assets.

• **GAAP-Based Budget Deficit/Government Obligations Are Out of Control.** The fiscal 2012 GAAP-based deficit likely topped $7 trillion, with total GAAP-Based U.S. obligations—including gross federal debt and net present value of unfunded liabilities—at close to $90 trillion (see Section III).

  o In terms of the backing for major Western currencies, U.S. fiscal conditions are the worst, by far, as best I have been able to determine. Varying estimates have been made of the obligations and unfunded liabilities of some other major Western countries and the euro currency block—all have problems—but consistent GAAP-based numbers simply are not available. In terms of severity of fiscal impairment, the United Kingdom and Japan appear to be next in line, following the United States.

• **Federal Reserve Accommodation Has Become Open-Ended under QE3.** Flight from the dollar is likely when the Federal Reserve moves, once again, to monetize U.S. Treasury debt. The global markets view such actions as highly inflationary and as direct efforts at debasing the U.S. dollar (see Section IV).

  o In the likely circumstance of the potential for a failed auction of U.S. Treasuries, or in the circumstance of massive dumping of foreign and/or domestically held U.S. Treasuries, the Fed probably would opt for monetization of Treasury debt, as opposed to allowing a crash of the financial markets and another potential systemic collapse. The precedent for such monetization has been set. QE3 is that mechanism for the monetization

• **Explosive Growth in Treasury Funding Needs; Troubled Auctions.** With the budget deficit likely to deteriorate beyond expectations, cash funding needs for U.S. government operations also would expand beyond current projections. That circumstance has the potential for destabilizing the
domestic financial markets and for setting up a possible failed auction, as discussed in the previous comments on Federal Reserve accommodation.

- **Renewed Threat of Systemic Collapse.** A major risk that also remains in play—likely coincident with some combination of the above circumstances—would be the movement of the U.S. financial system, again, to the brink of collapse. As before, the federal government and Federal Reserve would do everything within their powers to prevent such an event, creating, spending and lending whatever money was needed, and guaranteeing whatever assets had to be backed. As seen in 2008, the Fed’s actions likely would be similar, and would extend—out of necessity—to contain the threat of a global systemic collapse. Such would be subject, of course, to continuing, though increasingly reluctant support of the U.S. dollar in the global markets.

- **Euro Crisis Resolution.** Separately, at such time as the euro crisis is resolved—whether the solution is dissolution of the monetary union, a true fiscal union of the involved sovereign states, or something in between—the strongest players in the current currency union (such as Germany and the Netherlands) still will remain the strongest players in whatever circumstance follows. In the view of the global markets the stronger surviving euro entities likely will not be facing the debilitating sovereign solvency issues savaging what always have been the weaker euro players and the United States. Accordingly, global concerns should shift again, and perhaps already have started to do so, focusing on the proverbial elephant in the bathtub of sovereign solvency risk: the U.S. dollar.

- **Where Will All the Money Flowing Out of the U.S Dollar Go?** In a massive U.S. dollar sell-off, the flight would be to gold and most other currencies, but the currency and commodity markets would tend to balance the relative risks and liquidity needs with shifting exchange rates and prices.
  
  o For example, if there were much heavier flight to the Swiss franc than to the euro, that quickly would force the Swiss to break their current fixed-link to the euro. Both the euro and Swiss franc would rise relative to the dollar, but the Swiss franc likely by a much-higher percentage. As the dollar sinks in value relative to the franc, the higher franc value actually creates increased relative liquidity to absorb the tendered dollars. If the dollar dropped by 50%, for example, the Swiss could absorb twice the number of dollars that they could before the sell-off. At a drop of 90%, the Swiss could absorb ten-times as many dollars as before, etc.

- **Loss of U.S. Dollar Reserve Status.** As global dollar holders move to dump the U.S. currency and dollar-denominated paper assets, an early victim of intensifying flight from the dollar likely would be the U.S. dollar’s status as the world’s primary reserve currency. Loss of reserve status likely would be close to, or coincident with, other instabilities, exacerbating any dollar crisis. By itself, it could trigger a dollar crash. A strongly related area is the pricing of key commodities, particularly oil, in U.S. dollars. A move to price oil in terms of something other than the dollar would be highly inflationary for the United States, in the likely circumstance of an accompanying decline in the exchange rate of the U.S. currency. As shown in Graphs 32 through 37, some movement of reserves out of U.S. dollar assets already has taken place.

- **Surprises.** Always out there are surprise economic statistics and unexpected political, market or systemic developments that suddenly can tip the currency markets in a new direction.
Fundamentals Increasingly Are Against the U.S. Dollar. Underlying fundamentals that influence one currency’s relative valuation against another usually include, but are not limited to, the areas detailed in the updated Table II: Underlying Fundamentals versus the U.S. Dollar. All major fundamentals are negative now for the U.S. currency, as detailed in the table.

The updated Table III: Loss of U.S. Dollar Purchasing Power through October 2012, shows the loss of nearly all of the U.S. dollar’s purchasing power, since the beginning of the Federal Reserve’s operation in 1914, as measured against various inflation measures and gold and silver. In the last ten years, lost purchasing power as measured against the CPI-U has been 23.4%, 62.7% against the ShadowStats.com alternate-CPI measure (1980 Base), and by more than 80% versus gold and silver.

Graph 30: U.S. Merchandise Trade Deficit shows renewed deterioration in the U.S. trade shortfall, which had moved sharply, in both directions, in response to the large gyrations in oil prices that followed the 2008 financial panic.

A plot of the financial- and trade-weighted U.S. dollar indices in Graph 31 shows that despite wild currency swings, following the 2008 crisis, the current exchange rates for the U.S. dollar are holding within striking range of their historic lows.
### Table II: Underlying Fundamentals versus U.S. Dollar

<table>
<thead>
<tr>
<th>Fundamental</th>
<th>Relative Condition</th>
<th>Near-Term Trend</th>
<th>Impact on USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade Balance</td>
<td>Severe Deficit</td>
<td>Deterioration</td>
<td>Negative</td>
</tr>
<tr>
<td>Interest Rates</td>
<td>Extreme Low</td>
<td>Neutral</td>
<td>Negative (1)</td>
</tr>
<tr>
<td>Economic Growth</td>
<td>Low / Turning Down</td>
<td>Deterioration</td>
<td>Negative (2)</td>
</tr>
<tr>
<td>Inflation</td>
<td>High</td>
<td>Deterioration</td>
<td>Negative (3)</td>
</tr>
<tr>
<td>Financial-System Stability</td>
<td>Low</td>
<td>Deterioration</td>
<td>Negative (4)</td>
</tr>
<tr>
<td>Political Stability</td>
<td>Low</td>
<td>Deterioration</td>
<td>Negative (5)</td>
</tr>
<tr>
<td>Fiscal Condition</td>
<td>Extreme Instability</td>
<td>Deterioration</td>
<td>Negative (6)</td>
</tr>
</tbody>
</table>

(1) Basically at zero.
(2) Gaining recognition in the global markets.
(3) Further deterioration pending.
(4) Euro-area concerns irregularly have dominated global attention, with the effect of helping to prop up the dollar. Increasingly, the dollar will become the central concern.
(5) Election left divided government largely intact. Risk of contentious budget/debt negotiations
(6) U.S. GAAP based-deficit and obligations are the worst of major Western countries.

### Table III: Loss of U.S. Dollar Purchasing Power

<table>
<thead>
<tr>
<th>Loss of U.S. Dollar Purchasing Power</th>
<th>Through October 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Versus</td>
<td>Since January of 1914</td>
</tr>
<tr>
<td>Swiss Franc</td>
<td>-81.7%</td>
</tr>
<tr>
<td>CPI-U</td>
<td>-95.7%</td>
</tr>
<tr>
<td>Silver*</td>
<td>-98.6%</td>
</tr>
<tr>
<td>Gold</td>
<td>-98.9%</td>
</tr>
<tr>
<td>SGS-Alternate CPI</td>
<td>-98.9%</td>
</tr>
</tbody>
</table>

*December 2011 measured versus annual averages for 1914, 1933 and 1970.
Graph 30: U.S. Merchandise Trade Deficit

U.S. Merchandise Trade Balance (Annual Level)
Through 2012, Balance of Payments
2012 Annualized Nine Months to Sep (ShadowStats.com, Census)

Graph 31: U.S. Dollar Indices, Financial- versus Trade-Weighted

Financial- vs Trade-Weighted Dollar indices
Pending Loss of the U.S. Dollar’s Global Reserve Status. At such time as the U.S. dollar comes under heavy selling pressure, along with the dumping of dollar-denominated paper assets in the global markets, meaningful pressure likely will mount to move the U.S. dollar to some other status than as the world’s primary reserve currency.

The following series of Graphs 32 to 39, reflect varied measures of global holdings of reserve assets, including gold. The relative portions of global reserves denominated in U.S. dollars, as well as in euros, has declined since the systemic-panic of 2008, with movement into other currencies, gold and with the creation of added special drawing rights (SDR).

Graphs 32 and 33 relate to the Swiss National Bank (SNB) and its heavy intervention in buying euros, in order to establish a temporary peg between the Swiss franc (CHF) and euro (EUR). The effect also has been to prop the U.S. dollar (USD), with SNB foreign exchange reserves rising seven-fold since the 2008 panic. Since 1997, however, the SNB’s relative holdings of the USD have declined versus the EUR interventions, but the SNB also has moved some reserves into the yen (JPY) and the pound (GBP). It likely is just a question of time and mounting financial stresses as to when the SNB will back off from the EUR peg.

Graphs 34 to 37 relate to global holdings of reserve assets. The proportion of global reserves being held in the U.S. dollar has been in decline since before the 2008, with assets shifting to other currencies, gold and SDRs. Graphs 38 and 39 show shifts into greater reserve holdings of gold, since the 2007/2008 crises, for China, Russia, India and OPEC. Further, Table IV: Changing Gold Reserves shows the how gold holdings have shifted since fourth-quarter 2006 for the top-41 sovereign holders of gold, as of second-quarter 2012.

Those countries with the largest relative gains in gold holdings may have some discomfort with prospects for the ongoing safety and stability of the U.S. dollar.

Of the top ten holders of gold reserves, three have been major aquirers of physical gold in the post panic period: China, Russia and India.

OPEC members include Algeria, Angola (not reported), Equador, Iran (not reported), Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, UAE and Venzuela. The acquisition of OPEC gold inventory has been primarily with Saudi Arabia, Qatar and Venzuela. The decline in total OPEC gold holdings over the last year was due to the loss of some gold reserves in Libya, likely related to the change of government.
Graph 32: Foreign Exchange Reserves Held by Swiss National Bank (CHF)

Swiss National Bank -- Foreign Exchange Reserves
To Quarter-End 2q2012 (ShadowStats.com, SNB)

Graph 33: Foreign Exchange Reserves Held by Swiss National Bank (%)

Swiss National Bank -- Foreign Exchange Reserves
To Quarter-End 2q2012 (ShadowStats.com, SNB)
Graph 36: Percentage Breakout of Global Reserve Assets in 2006

Percentage Breakout of
Global Holdings of Reserve Assets
Dec 31, 2006 (ShadowStats.com, WGC, IMF)

- USD
- EUR
- Gold
- SDR

Graph 37: Percentage Breakout of Global Reserve Assets in 2012

Percentage Breakout of
Global Holdings of Reserve Assets
Mar 31, 2012 (ShadowStats.com, WGC, IMF)

- USD
- EUR
- Gold
- SDR
### Table IV: Changing Gold Reserves

Global Holdings of Gold Reserves and Changes from Pre-Panic Levels
(Source: ShadowStats.com, World Gold Council)

<table>
<thead>
<tr>
<th>Country*</th>
<th>2q2012 Tonnies**</th>
<th>Global Rank in Holdings</th>
<th>% Change*** from 4q2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mexico</td>
<td>125</td>
<td>26</td>
<td>4,255.0%</td>
</tr>
<tr>
<td>Korea</td>
<td>54</td>
<td>40</td>
<td>318.6%</td>
</tr>
<tr>
<td>Belarus</td>
<td>50</td>
<td>41</td>
<td>147.2%</td>
</tr>
<tr>
<td>Russia</td>
<td>918</td>
<td>7</td>
<td>128.7%</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>323</td>
<td>14</td>
<td>125.9%</td>
</tr>
<tr>
<td>Turkey</td>
<td>244</td>
<td>19</td>
<td>110.4%</td>
</tr>
<tr>
<td>Thailand</td>
<td>152</td>
<td>23</td>
<td>81.5%</td>
</tr>
<tr>
<td>China</td>
<td>1,054</td>
<td>5</td>
<td>75.7%</td>
</tr>
<tr>
<td>India</td>
<td>558</td>
<td>10</td>
<td>55.9%</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>102</td>
<td>32</td>
<td>50.8%</td>
</tr>
<tr>
<td>Philippines</td>
<td>194</td>
<td>21</td>
<td>35.3%</td>
</tr>
<tr>
<td>Argentina</td>
<td>62</td>
<td>39</td>
<td>12.8%</td>
</tr>
<tr>
<td>Venezuela</td>
<td>366</td>
<td>13</td>
<td>2.4%</td>
</tr>
<tr>
<td>South Africa</td>
<td>125</td>
<td>27</td>
<td>0.8%</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>323</td>
<td>14</td>
<td>125.9%</td>
</tr>
<tr>
<td>Australia</td>
<td>80</td>
<td>33</td>
<td>0.1%</td>
</tr>
<tr>
<td>Poland</td>
<td>103</td>
<td>31</td>
<td>0.0%</td>
</tr>
<tr>
<td>Singapore</td>
<td>127</td>
<td>24</td>
<td>0.0%</td>
</tr>
<tr>
<td>Egypt</td>
<td>76</td>
<td>35</td>
<td>0.0%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>310</td>
<td>15</td>
<td>0.0%</td>
</tr>
<tr>
<td>Italy</td>
<td>2,452</td>
<td>3</td>
<td>0.0%</td>
</tr>
<tr>
<td>Japan</td>
<td>765</td>
<td>8</td>
<td>0.0%</td>
</tr>
<tr>
<td>Lebanon</td>
<td>287</td>
<td>16</td>
<td>0.0%</td>
</tr>
<tr>
<td>Algeria</td>
<td>174</td>
<td>22</td>
<td>0.0%</td>
</tr>
<tr>
<td>Greece</td>
<td>112</td>
<td>29</td>
<td>0.0%</td>
</tr>
<tr>
<td>Kuwait</td>
<td>79</td>
<td>34</td>
<td>0.0%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>73</td>
<td>36</td>
<td>0.0%</td>
</tr>
<tr>
<td>United States</td>
<td>8,133</td>
<td>1</td>
<td>0.0%</td>
</tr>
<tr>
<td>Denmark</td>
<td>67</td>
<td>37</td>
<td>0.0%</td>
</tr>
<tr>
<td>Portugal</td>
<td>382</td>
<td>12</td>
<td>0.0%</td>
</tr>
<tr>
<td>Taiwan</td>
<td>423</td>
<td>11</td>
<td>-0.1%</td>
</tr>
<tr>
<td>Belgium</td>
<td>227</td>
<td>20</td>
<td>-0.1%</td>
</tr>
<tr>
<td>Germany</td>
<td>3,396</td>
<td>2</td>
<td>-0.8%</td>
</tr>
<tr>
<td>Romania</td>
<td>104</td>
<td>30</td>
<td>-0.9%</td>
</tr>
<tr>
<td>Pakistan</td>
<td>64</td>
<td>38</td>
<td>-1.4%</td>
</tr>
<tr>
<td>Austria</td>
<td>280</td>
<td>18</td>
<td>-3.0%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>612</td>
<td>9</td>
<td>-4.4%</td>
</tr>
<tr>
<td>France</td>
<td>2,435</td>
<td>4</td>
<td>-10.5%</td>
</tr>
<tr>
<td>Libya</td>
<td>117</td>
<td>28</td>
<td>-18.9%</td>
</tr>
<tr>
<td>Switzerland</td>
<td>1,040</td>
<td>6</td>
<td>-19.4%</td>
</tr>
<tr>
<td>Sweden</td>
<td>126</td>
<td>25</td>
<td>-20.7%</td>
</tr>
<tr>
<td>Spain</td>
<td>282</td>
<td>17</td>
<td>-32.4%</td>
</tr>
<tr>
<td><strong>Global Total</strong></td>
<td>28,065</td>
<td></td>
<td>3.6%</td>
</tr>
</tbody>
</table>

* Holdings of more than 50 tonnes as of 2q2012.
** Metric ton: one tonne = 32,150.722 troy ounces.
*** Rounded to first decimal point.
Gold Remains the Ultimate Hedge As A Store of Wealth. For those living in a U.S. dollar-denominated world, physical gold remains the primary hedge against the ultimate dollar crisis, along with physical silver and assets outside the U.S. dollar, in stronger major currencies, such as the Swiss franc, Australian dollar and Canadian dollar.

In this circumstance, it never is too early to move to protect the purchasing power of one’s wealth and assets against the nearing dollar tempest. The prices of precious metals and currency values will remain volatile and become increasingly unstable as the currency crisis breaks. Over the long haul, though, gold will remain the primary hedge against lost purchasing power. Whether gold is purchased at $500, $1,500 or $5,000 per ounce, the upside potential effectively is unlimited against the U.S. dollar in a hyperinflation. Whether prices hit $10,000, $100,000 per ounce or much higher, it is important to remember that any apparent “profits” in dollar terms largely are no more than a reflection of the preserved purchasing power of the dollars initially invested in gold.

Once one’s core assets are preserved in terms of purchasing power and liquidity, longer-term hedges such as real estate and gold-mining stocks are worth consideration. “Longer-term” is used to describe these assets, since they conceivably could face temporary liquidity problems in the most difficult times. Please review Hyperinflation 2012 for other comments in this area, as well as in terms of stockpiling certain goods for personal consumption, and for a potential a barter situation.

Following are the regular graphs of gold versus the Swiss franc, oil and silver.
Graph 41: Gold versus Oil

Gold versus Oil (WTI/Brent)
Monthly Average Prices to Oct 2012, Pre-1987 is WTI (ShadowStats.com, Kitco, DOE)

Graph 42: Gold versus Silver

Gold versus Silver
Monthly Average Price Levels to October 2012
Pre-1981 Silver is Year-End (ShadowStats.com, Kitco, Handy & Harman)