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

COMMENTARY NUMBER 562
Shutdown of the Federal Government

October 1, 2013

Renewed Battle Over U.S. Sovereign Solvency

President's Working Group on Financial Markets Likely in Play

Government Economic-Reporting Shutdown
Excludes Data from Privately-Owned Federal Reserve

PLEASE NOTE: The next regular Commentary *is scheduled for Friday, October 4th, covering August money supply M3 and systemic-liquidity conditions. For the duration of the shutdown of the Federal Government, federal statistical agencies (including the Bureau of Labor Statistics, the Census Bureau and the Bureau of Economic Analysis) have suspended issuance of regular economic releases. This does not apply to releases from the privately-owned Federal Reserve, or from other non-government entities. As usual, ShadowStats* Commentaries *will be published at least once per week. See the* schedule *for full details.*

Best wishes to all — John Williams

THE ISSUE IS LONG-RANGE U.S. SOVEREIGN SOLVENCY

The battle over the long-range sovereign solvency of the United Stated has resumed, following the inability of those controlling the U.S. government to address the issue meaningfully during the collapsed negotiations seen in the July-August 2011 period. The unfolding catastrophe in the control and containment of mortally-unbalanced federal fiscal conditions should intensify in the next week or two, as the debt-ceiling crisis hits the threshold of U.S. Treasury forbearance.

What is at risk here is not just the usual, extremely-virulent political bickering that increasingly has dominated the headline communications between competing philosophies within the political system, but rather the financial survival of the United States as we know it. To balance the federal deficit, both in terms of the accounting-gimmicked cash basis and in terms of generally accepted accounting principles (see *No. 500: Special Commentary*), significant political and economic pain are required, but the American people could handle the crisis, if the only politicians were honest with them.

Left unchecked, or even worse, addressed with hype but little of actual substance, the exploding GAAP-based federal budget deficit promises eventual U.S. hyperinflation. The current crisis is a good candidate for triggering massive foreign-exchange sell-off and dumping of the U.S. dollar.

There is no further kicking the proverbial can down the road; this is the end game. In terms of a nonfunctioning U.S. political establishment and a heavily-overvalued U.S. dollar, the patience of the global currency markets has been worn down to the bone. Lack of meaningful, corrective fiscal action in the immediate future most likely would trigger a significant decline in the exchange-rate value of the U.S. currency. In turn, that would trigger rising oil and gasoline prices, intensifying domestic inflationary pressures, and setting the early conditions for a hyperinflationary environment that remains likely by the end of next year.

As to those politicians afraid to act, for fear of offending their constituents and hurting re-election prospects, consider the circumstances if the timing and conditions of the hyperinflation discussed above come to pass. Those who are perceived as not having acted—political party or individual—will have no chance at reelection in either 2014 or 2016. (See details of the hyperinflation outlook in *Hyperinflation 2012* and updated in *Commentary No. 559* and in the summary outlook in the *Hyperinflation Watch* section).

As a Symptom of a Failing Political System, a Government Shutdown Should Be Savaging the Markets and U.S. Dollar. Thank goodness for the President's Working Group on Financial Markets! Post-shutdown selling of stocks and the U.S. dollar and buying of gold was averted, despite early selling of stocks and the dollar, as the risks of a shutdown moved to a virtual certainty.

Created under President Ronald Reagan in the wake of the 1987 stock-market crash, the Plunge Protection Team (PPT), as some call it, was intended as a vehicle of market stability, a group assigned the responsibility of maintaining orderly financial markets. Headed by the U.S. Treasury Secretary and the Chairman of the Federal Reserve, the PPT has intervened largely to prop the stock market, as seen with the S&P downgrade in 2011 of U.S. Treasury securities. Former Fed Chairman Alan Greenspan also indicated PPT actions had been taken to buy the U.S. dollar and to sell gold and oil during Iraqi crises.

What happened overnight with the shutdown was a circumstance that had to be watched by the PPT. Supportive actions for stocks and the U.S. dollar, and continued selling of gold were extremely likely. Market fundamentals eventually will prevail.

Developing circumstances here will be addressed as necessary.

HYPERINFLATION WATCH

Hyperinflation Outlook—Updated Summary. This *Hyperinflation Outlook* summary has been updated from *Commentary No. 559* of September 19th. The minimal changes are underlined. The summary is intended as background material for new subscribers and for those looking for a brief version of the broad outlook on the economic, systemic and inflation crises that face the United States in the year or so ahead.

Background Material. *No. 527: Special Commentary* (May 2013) supplemented *No. 485: Special Commentary* (November 2012), reviewing shifting market sentiment on a variety of issues affecting the U.S. dollar and prices of precious metals. *No. 485*, in turn, updated *Hyperinflation 2012* (January 2012)—the base document for the hyperinflation story—and the broad outlook for the economy and inflation, as well as for systemic-stability and the U.S. dollar. Of some use, here, also is the *Public Comment on Inflation*.

These are the primary articles outlining current conditions and the background to the hyperinflation forecast, and they are suggested reading for subscribers who have not seen them and/or for those who otherwise are trying to understand the basics of the hyperinflation outlook. The fundamentals have not changed in recent years, other than events keep moving towards the circumstance of a domestic U.S. hyperinflation by the end of 2014. Nonetheless, a fully-updated hyperinflation report is planned in the month ahead.

Beginning to Approach the End Game. Nothing is normal: not the economy, not the financial system, not the financial markets and not the political system. The financial system still remains in the throes and aftershocks of the 2008 panic and near-systemic collapse, and from the ongoing responses to same by the Federal Reserve and federal government. Further panic is possible and hyperinflation remains inevitable.

Typical of an approaching, major turning point in the domestic- and global-market perceptions, bouts of extreme volatility and instability have been seen with increasing frequency in the financial markets, including equities, currencies and the monetary precious metals (gold and silver). Consensus market expectations on the economy and Federal Reserve policy also have been in increasing flux. The FOMC and Federal Reserve Chairman Ben Bernanke have put forth a plan for reducing and eventually ending quantitative easing in the form of QE3. The tapering or cessation of QE3 is contingent upon the U.S. economy performing in line with overly-optimistic economic projections provided by the Fed. Initially, market reaction pummeled stocks, bonds and gold. Yet, the early talk of tapering QE3 was little more than jawboning, aimed either at placating a growing chorus of Fed critics or at manipulating variously the gold, currency and domestic-stock markets.

Underlying economic reality remains much weaker than Fed projections. As actual economic conditions gain broader recognition, market sentiment even could shift from what now is no imminent end to QE3, to an expansion of QE3. The markets and the Fed are stuck with underlying economic reality, and, increasingly, they are beginning to to recognize same. Business activity remains in continued and deepening trouble, and the Federal Reserve is locked into quantitative easing by persistent problems now well beyond its control. Specifically, banking-system solvency and liquidity remain the primary concerns for the Fed, driving the quantitative easing. Economic issues are secondary concerns for the Fed; they are used as political cover for QE3. That cover will continue for as long as the Fed needs it.

At the same time, deteriorating expectations for domestic political stability reflect government scandals and conflicting policy actions, in addition to the dominant global-financial-market concern of there being no viable prospect of those controlling the U.S. government addressing the long-range sovereign-solvency issues of the United States government. These factors, in combination, show the end game to be at hand. The government shutdown of October 1st was the beginning of the big battle over long-range sovereign solvency of the United States. The debt-ceiling crisis also is imminent.

The most visible and vulnerable financial element to suffer early in this crisis likely will be the U.S. dollar in the currency markets (all dollar references here are to the U.S. dollar, unless otherwise stated). Heavy dollar selling should evolve into massive dumping of the dollar and dollar-denominated paper assets, at any time, with little or no warning. Dollar-based commodity prices, such as oil, should soar, accelerating the pace of domestic inflation. In turn, that circumstance likely will trigger some removal of the U.S. dollar from its present global-reserve-currency status, which would further exacerbate the currency and inflation problems tied to the dollar.

This still-forming great financial tempest has cleared the horizon; its early ill winds are being felt; and its impact on the United States and those living in a dollar-based world will dominate and overtake the continuing economic and systemic-solvency crises of the last eight years. The issues that never were resolved in the 2008 panic and its aftermath are about to be exacerbated. Based on precedents established in 2008, likely reactions from the government and the Fed would be to throw increasingly worthless money at the intensifying crises, hoping to push the problems even further into the future. Such attempts to save the system, however, all have exceptional inflationary implications.

The global financial markets appear ready to move beyond the forced patience with U.S. policies that had been induced by the financial terror of the 2008 panic. Accordingly, the U.S. dollar faces likely extreme and negative turmoil in the months ahead. A domestic hyperinflationary environment still should evolve from something akin to these crises before the end of next year (2014). The shifting underlying fundamentals are discussed in *No. 527: Special Commentary*; some of potential breaking crises will be expanded upon in the next revision to the hyperinflation report.

Still Living with the 2008 Crisis. Despite the happy news from the redefined GDP series that the recession was shallower, and the recovery more rapid, than previously estimated, there still never has been an actual recovery following the economic downturn that began in 2006, and collapsed into 2008 and 2009. No other major economic series has confirmed the pattern of activity now being reported in the GDP. Indeed, 2012 household income data from the Census Bureau show no recovery whatsoever.

Instead, what followed was a protracted period of business stagnation that began to turn down anew in second- and third-quarter 2012 (see the corrected GDP graph in the *Opening Comments* section of *Commentary No. 552*). The official recovery seen in GDP has been a statistical illusion generated by the use of understated inflation in calculating key economic series (see *No. 527: Special Commentary* and *Public Comment on Inflation*). Nonetheless, given the nature of official reporting, the renewed downturn still should gain eventual recognition as the second-dip in a double- or multiple-dip recession, with current reporting in basic economic series, such as housing, retail sales and production (not the GDP), coming into synchronization with a renewed downturn in broad economic activity starting in second- and third-quarter 2013.

What continues to unfold in the systemic and economic crises is just an ongoing part of the 2008 turmoil. All the extraordinary actions and interventions bought a little time, but they did not resolve the various crises. That the crises continue can be seen in deteriorating economic activity and in the ongoing panicked actions by the Federal Reserve, where it still proactively is monetizing U.S. Treasury debt at a pace suggestive of a Treasury that is unable to borrow otherwise. As of August 2013, the Fed had monetized in excess of 100% of the net issuance of U.S. Treasury debt, since the beginning of the calendar year.

The Fed's unconscionable market manipulations and games playing in fueling speculation over the future of quantitative easing clearly were used to move the U.S. dollar (the purpose of initial quantitative easing was U.S. dollar debasement). QE3 and continuing efforts at dollar-debasement are not about to go away. Further complicating the circumstance for the U.S. currency is the increasing tendency of major U.S. trading partners to move away from using the dollar in international trade. The loss of some reserve status for the U.S. dollar is likely, as the crises break, and that would intensify both the dollar-selling and domestic U.S. inflationary pressures.

The Fed's recent and ongoing liquidity actions themselves suggest a signal of deepening problems in the financial system. Mr. Bernanke admits that the Fed can do little to stimulate the economy, but it can create systemic liquidity and inflation. Accordingly, the Fed's continuing easing moves appear to have been primarily an effort to prop-up the banking system and also to provide back-up liquidity to the U.S. Treasury, under the political cover of a "weakening economy." Mounting signs of intensifying domestic banking-system stress are seen in soft annual growth in the broad money supply, despite a soaring pace of annual growth in the monetary base, and in global banking-system stress that followed the crisis in Cyprus and continuing, related aftershocks.

Still Living with the U.S. Government's Fiscal Crisis. Again, as discussed early on in *No. 527: Special Commentary*, the U.S. Treasury now has reached the final stages of going through extraordinary accounting gimmicks, in order to avoid exceeding the federal-debt ceiling. The crisis is at hand, with a deadline in the week or two ahead for resolving related issues, including—in theory—significant budget-deficit cuts.

Both Houses of Congress have put forth outlines of ten-year budget proposals that remain shy on detail. The ten-year plan by the Republican-controlled House proposes to balance the cash-based deficit as well as to address issues related to unfunded liabilities. The plan put forth by the Democrat-controlled Senate does not look to balance the cash-based deficit. Given continued political contentiousness and the use of unrealistically positive economic assumptions to help the budget projections along, little but gimmicked numbers and further smoke-and-mirrors are likely to come out of upcoming negotiations. There still appears to be no chance of a forthcoming, substantive agreement on balancing the federal deficit.

Indeed, ongoing and deepening economic woes assure that the usual budget forecasts—based on overly-optimistic economic projections—will fall far short of fiscal balance and propriety. Chances also remain nil for the government fully addressing the GAAP-based deficit that hit $6.6 trillion in 2012, let alone balancing the popularly-followed, official cash-based accounting deficit that was $1.1 trillion in 2012 (see *No. 500: Special Commentary*). Recent reductions reported in the year-to-date cash-based 2013 deficit reflect gimmicks such as the U.S. government declaring itself dividends out of government-backed and controlled Fannie Mae and Freddie Mac. Those dividends also have helped the Treasury operate around the limits of the current debt ceiling. If the government consolidated those entities into its financial statements, as would happen in the corporate world, the deficit position would be much bleaker, as it is otherwise with generally accepted accounting principles or GAAP-based accounting.

Efforts at delaying meaningful fiscal action, including briefly postponing conflict over the Treasury's debt ceiling, bought the politicians in Washington minimal time in the global financial markets, but the time has run out and patience in the global markets is near exhaustion. The global markets previously had expressed their extreme discomfort with the unresolved longer-range sovereign solvency issues of the United States, by dumping dollars at the time of the failed July/August 2011 fiscal negotiations. The continuing unwillingness and political inability of the current government to address those issues, only pushes along the regular unfolding of events that eventually will trigger a massive flight from the U.S. dollar and a domestic hyperinflation, as discussed in *Commentary No. 491*.

U.S. Dollar Remains Proximal Hyperinflation Trigger. The unfolding fiscal catastrophe, in combination with the Fed's direct monetization of Treasury debt, eventually (more likely sooner rather than later) will savage the U.S. dollar's exchange rate, boosting oil and gasoline prices, and boosting money supply growth and domestic U.S. inflation. Relative market tranquility has given way to mounting instabilities, and extreme market turmoil likely looms, despite the tactics of delay by the politicians and ongoing obfuscation by the Federal Reserve.

This should become increasingly evident as the disgruntled global markets begin to move sustainably against the U.S. dollar. As discussed earlier, a dollar-selling panic is likely this year—still of reasonably high risk in the near-term—with its effects and aftershocks setting hyperinflation into action in 2014. Gold remains the primary and long-range hedge against the upcoming debasement of the U.S. dollar, irrespective of any near-term price gyrations in the gold market.

The rise in the price of gold in recent years was fundamental. The intermittent panicked selling of gold has not been. With the underlying fundamentals of ongoing dollar-debasement in place, the upside potential for gold, in dollar terms, is limited only by its inverse relationship to the purchasing power of the U.S. dollar (eventually headed effectively to zero). Again, physical gold—held for the longer term—remains as a store of wealth, the primary hedge against the loss of U.S. dollar purchasing power.

