

HYPERINFLATION 2014—THE END GAME BEGINS
2014 Update to the ShadowStats *Hyperinflation Report* — First Installment

No. 587: SPECIAL COMMENTARY

January 7, 2014

**Extremely Difficult Circumstances in the Year Ahead:
Confluence of Economic and Systemic Crises Should Intensify**

**With Global Confidence in Dollar Rattled by Uncontrollable Fiscal and Monetary Excesses,
U.S. Government and the Federal Reserve Have Limited Options to Address Panics**

Heavy Selling of U.S. Dollar Remains Likely Proximal Trigger for Inflation Pick-Up

Developing Hyperinflation Would Push Ongoing Recession into Deep Depression

Physical Gold Remains Primary Hedge for Preserving Wealth and Assets

Opening Comments

Extraordinary Economic Distress, Financial Crises and Panics Likely Will Dominate 2014.

Nothing is normal: not the economy, not the financial markets, not the financial system and not the political system. The year ahead will be an extraordinarily difficult time, with a confluence of already-intensifying crises and likely panics pummeling the moribund economy, roiling the markets, and destabilizing the financial and political systems. With the federal government and Federal Reserve locked into their respective systemic-destructive fiscal and monetary policies, a related, continuing

massive loss of global and domestic confidence in the U.S. dollar, should lead to an outright dumping of the U.S. currency in the global markets, setting the initial stages of a hyperinflationary great depression.

The timing of the hyperinflation onset by the end of 2014 remains in place, with the odds of that occurrence estimated at 90%.

Overt and covert official interventions in the financial markets were of substance in 2013, designed to mitigate the ongoing impact of the evolving crises. As will be discussed, those interventions ranged from the physical, to jawboning with window dressing, and they were used with increasing frequency in the last year in efforts to depress the price of gold, and to support the U.S. dollar, and the U.S. stock and bond markets.

Ultimately, interventions—devoid of changes to underlying fundamentals—tend to fail against the massive pressures of the real-world activity driving the markets. Still, further interventions are likely in the year ahead, including possible regulatory constraints in certain markets or segments of the economy. Nonetheless, physical gold remains the basic hedge for preserving the purchasing power of one's wealth and assets in this still-developing era of dollar debasement.

Background to the 2014 Report

This *First Installment* of *Hyperinflation 2014—The End Game Begins* covers the hyperinflation forecast and underlying rationale, including assessments of historical inflation and the current crises in Federal Reserve monetary policy and the federal government's fiscal policies. The U.S. government has demonstrated an inability and unwillingness to address its longer-term solvency problems. Key points from the *Second Installment* also are summarized.

The *Second Installment* is targeted for publication around the end of the month, subsequent to most December and annual 2013 economic reporting. It will review economic history, detail current economic activity and the likely outlook. It also will cover inflation-related investment considerations, options for personal protection in, and financial hedging against, the likely turmoil ahead, as well possible government responses to the crises, including options for mitigating the devastating impact of a hyperinflation on broad U.S. economic activity.

For new subscribers, and for those looking to refresh their memories in advance of the *Second Installment*, the general outlook has not changed. Circumstances just have evolved, moving the domestic environment ever closer to the hyperinflation crisis and full debasement of the U.S. dollar. Accordingly, much of the economic background and actionable options for protecting oneself and one's assets already are detailed in [Hyperinflation 2012](#), as discussed there in Chapters 4 (page 23), 5 (page 38), and 9 (page 65). The latest detail on broad economic activity is found in *Commentaries* [No. 575](#) and [No. 585](#).

Indeed, where the current underlying circumstances and outlook are much as described in the January 2012 release of [Hyperinflation 2012](#), there is some repetition of text here. Nonetheless, all chapters have significant new text and updated detail.

The forecast of a U.S. hyperinflation has been in place since at least 2006. Those who have read the various ShadowStats reports on hyperinflation—as opposed to just catching occasional sensationalized headlines in the press—usually recognize that the forecast has been of a future circumstance, in what

used to be the distant future. In the early writings, the outside time limit for the crisis was 2018 or 2019, the end of the current decade. That outside timing was moved in closer in time, to 2014, following the near-collapse of the financial system in 2008. For those interested, the full series of hyperinflation reports is described and linked at the end of the *Definitions and Background* section.

Again, at this onset to the New Year, the hyperinflation timing remains in place for 2014. By its nature, a currency panic—the likely proximal trigger of the hyperinflation event—is difficult to time. With all the underlying fundamentals for the collapse of the U.S. dollar having been in place for some time, the potential for an imminent break in the system also has been and remains in place. In the wake of the Panic of 2008, the hyperinflation timing reflects the period in which many of the economic- and systemic-related crises of 2008 likely will intensify or resurface, in a confluence of market-roiling circumstances. Extraordinary financial intervention by the federal government and Federal Reserve in 2008 saved the U.S. banking system from collapse, but those actions did little more than to push mortal problems for the economy and financial system a couple of years down the road. Those actions also had inflationary consequences, and they limited the flexibility of federal-government and Federal Reserve options in addressing future crises, accelerating the approach of a day of reckoning for the U.S. dollar into the near future. The U.S. currency has been set up for its ultimate demise, in debilitating inflation.

Please note that *Chapter 1—Overview and Executive Summary* begins on page 12.

Best wishes to all for a most healthy, happy and prosperous New Year! — John Williams

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Definitions and Background to the Hyperinflation Reports

Defining a Hyperinflationary Great Depression

Deflation, Inflation and Hyperinflation

Inflation broadly is defined in terms of a rise in general prices usually due to an increase in the amount of money in circulation. That circumstance may reflect and/or be exacerbated by relative foreign-exchange weakness of the domestic currency. The inflation/deflation issues defined and discussed in this missive are as applied to consumer goods and services, not to the pricing of financial assets, unless that has been specified otherwise.

In terms of hyperinflation, there have been a variety of definitions used over time. The circumstance envisioned ahead is not one of double- or triple- digit annual inflation, but more along the lines of seven- to ten-digit inflation seen in other circumstances during the last century. Under such circumstances, the currency in question becomes worthless, as seen in Germany (Weimar Republic) in the early 1920s (see *Chapter 2*), in Hungary after World War II, in the dismembered Yugoslavia of the early 1990s and more recently in Zimbabwe (see *Chapter 2*), where the aggregate pace of hyperinflation likely was the most extreme ever seen.

The historical culprit generally has been the use of fiat currencies—currencies with no hard-asset backing such as gold—and the resulting massive printing of currency that the issuing authority needed to support its spending, when it did not have the ability, otherwise, to raise enough money for its perceived needs, through taxes or other means.

Ralph T. Foster (*Foster*) in *Fiat Paper Money, The History and Evolution of Our Currency* (see *Recommended Further Reading*) details the history of fiat paper currencies from 11th Century Szechwan, China, to date, and the consistent collapse of those currencies, time-after-time, due to what appears to be the inevitable, irresistible urge of issuing authorities to print too much of a good thing.

- **Definitions of how price movements are characterized:**

Deflation: A decrease in the prices of consumer goods and services, usually tied to a contraction of money in circulation. Formal deflation is measured in terms of year-to-year change.

Inflation: An increase in the prices of consumer goods and services, usually tied to an increase of money in circulation.

Hyperinflation: Extreme inflation, minimally in excess of four-digit annual percent change, usually along the lines of seven- to ten-digit inflation, where the involved currency becomes worthless. A fairly crude definition of hyperinflation is a circumstance, where, due to extremely rapid price increases, the largest pre-hyperinflation bank note (\$100 bill in the United States) becomes worth more as functional toilet paper/tissue or wallpaper than as currency.

As discussed in *Chapter 3—Historical U.S. Inflation and U.S. Dollar Debasement*, the domestic economy has been through periods of both major inflation and deflation, usually tied to wars and their aftermaths. Such, however, preceded the U.S. going off the domestic gold standard in 1933 and abandoning international gold convertibility in 1971. The era of the modern fiat dollar generally has been one of persistent and slowly debilitating inflation.

- **Terminology describing the inflation status of reported economic or financial data:**

Nominal or Current Dollar: Describes numbers that have not been adjusted for the effects of inflation.

Real, Constant Dollar or Deflated: Describes numbers that have been adjusted for the effects of inflation, using a base period for consistent comparison. For example, the headline reporting of the CPI-U is based on the dollar as it was worth in the average of the 1982-1984 period, where a number so adjusted reflects the value it would have had in the base period (subject of course to the meaningfulness of the inflation data).

- **Various measures of consumer price inflation and other inflation referenced in this report:**

The Consumer Price Index (CPI): The CPI is the primary consumer inflation measure published by U.S. Government, through the Bureau of Labor Statistics (BLS), Department of Labor (see [Public Comment on Inflation](#)):

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

C-CPI-U (Chained CPI-U): The C-CPI-U is a fully substitution-based (as opposed to the former fixed basket of goods) inflation measure, like the deflator used for personal consumption expenditure (PCE) in the GDP. The C-CPI was designed by the government as a replacement for the CPI in calculating cost-of-living adjustments (COLA) for government programs such as Social Security. With the C-CPI showing the lowest inflation of the CPI measures, the concept has been viewed positively by Congress as a way to reduce the federal deficit (that basic concept has been used before in redefining the CPI). Unlike the CPI reporting, which is set forever on a not-seasonally-adjusted basis, once reported, the C-CPI-U faces revisions for two years. That could

become a major issue in the C-CPI replacing the CPI in COLA adjustments (see [Public Comment on Inflation](#) and [Commentary No. 583](#)).

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

CPI-U-RS (Current Methods CPI): The CPI-U-RS is the current CPI-U with its history restated as if all the new methodologies introduced since the 1980s had been in place from day one. The involved changes have moved the CPI away from being a measure of inflation for a fixed basket of goods and services, away from being a measure of the cost of living of maintaining a constant standard of living, and away from fully accounting for inflation in out-of-pocket expenses.

In government reporting, the measure has been used primarily by the Census Bureau in deflating income measures in its annual poverty survey. The use of the resulting lower historical inflation rates shown in the CPI-U-RS, versus the CPI-U, has the effect of making current inflation-adjusted data, such as income, look relatively stronger on an historical basis (see [Public Comment on Inflation](#) for further details).

ShadowStats Alternate CPI-U Measure: The ShadowStats Alternate CPI Measures (based on 1980, and separately based on 1990 reporting methodologies) are an attempt to reverse changes to CPI inflation methodologies since 1980 (also since 1990). The changes to the CPI methodologies altered the CPI concept, from being a measure of the cost of living needed to maintain a constant standard of living, to a measure of a cost of living that reflects a substitution-based, declining standard of living. The CPI concept also was changed from being a measure reflecting out-of-pocket expenses, to a measure adjusted by nebulous hedonic-quality adjustments, which no longer reflects actual spending experience. The ShadowStats measures are based primarily on a reverse engineering of the CPI-U-RS. (See the accompanying *Graphs 1* and *2*, and [Public Comment on Inflation](#) for further details).

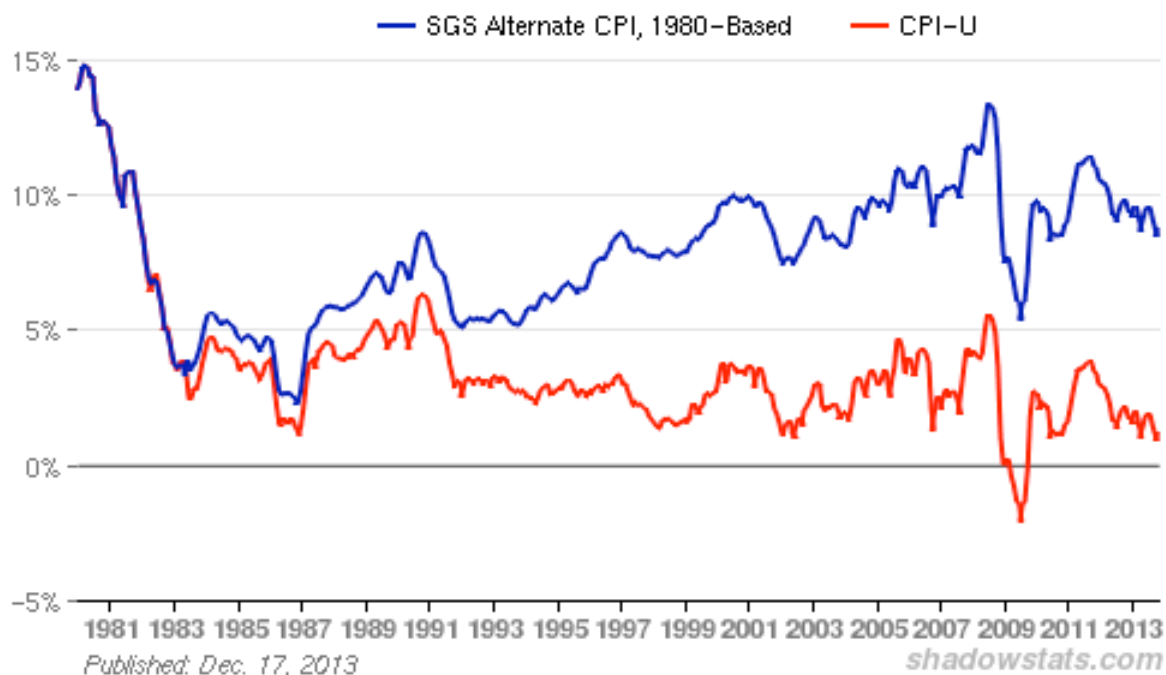
GNP/GDP Implicit Price Deflator (IPD): The IPD is the rate of inflation for the aggregate economy (including consumer, business, housing, government and trade sectors) that is used in deflating nominal or current-dollar Gross National Product (GNP), Gross Domestic Product (GDP) and components of same, to “real,” constant-dollar or inflation-adjusted levels. It understates GDP inflation, resulting in an overstatement of real (inflation-adjusted) growth. (See [Public Comment on Inflation](#) and *Chapter 1* for further details).

Core Inflation: Inflation net of food and energy cost. This is a concept popularized by the Federal Reserve in an effort to report and focus on the lowest possible inflation rate that the government could produce. Over periods of a year or more, the use of “core” inflation is nonsensical in terms of measuring consumer inflation that has any relationship to common experience. Food and energy account for 24.6% of the CPI-U and 27.6% of the CPI-W. A measure particularly popular with Fed is the core PCE deflator, where PCE is the personal consumption expenditure component of the GDP, a fully substitution-based (reduced inflation reporting) consumer inflation number. (See [Public Comment on Inflation](#) for further details).

Graph 1: ShadowStats Alternate Consumer Price Measure (1980-Based Methodologies)

Consumer Inflation - Official vs ShadowStats (1980-Based) Alternate

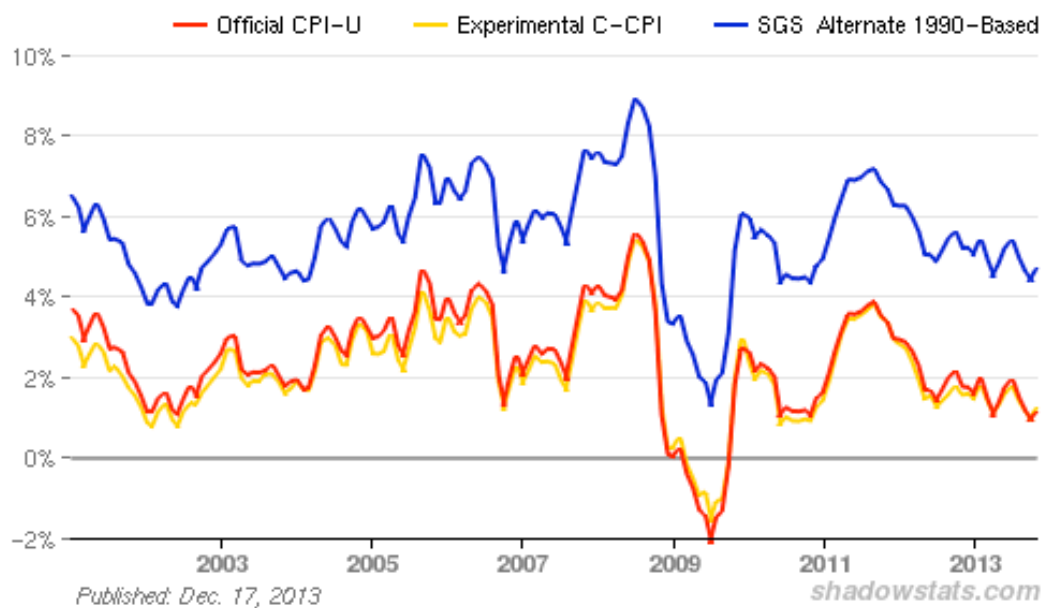
Year to Year Change. Through Nov. 2013. (BLS, SGS)



Graph 2: ShadowStats Alternate Consumer Price Measure (1990-Based Methodologies)

Consumer Inflation - Official vs ShadowStats (1990-Based) Alternate

CPI-U Year to Year Change. Not Seasonally Adjusted. to Nov. 2013 (BLS, SGS)



Recession, Great Recession, Depression and Great Depression, Recovery and Economic Boom

Several decades back, I tried to tie down the definitional differences between a recession, depression and a great depression with the Bureau of Economic Analysis (BEA), the National Bureau of Economic Research (NBER) and a number of private economists. I found that there was no consensus on the matter, where popular usage of the term “depression” had taken on the meaning of a severe recession, so I set some definitions that the various parties (neither formally nor officially) thought were within reason.

If you look at the plot of the level of economic activity during a downturn, you will see something that looks like a bowl, with activity recessing on the downside and recovering on the upside. The term used to describe this bowl-shaped circumstance before World War II was “depression,” while the downside portion of the cycle was called “recession,” and the upside was called “recovery.” Before World War II, all downturns simply were referred to as depressions. In the wake of the Great Depression of the 1930s, however, a euphemism was sought for describing future economic contractions, so as to avoid evoking memories of that earlier, financially painful time.

Accordingly, a post-World War II downturn was called “recession.” Officially, now, the deepest post-World War II recession was from December 2007 through June 2009, with a peak-to-trough contraction in the inflation-adjusted quarterly GDP activity level of 4.3% (revised the from 5.1% contraction in place as of the prior hyperinflation report). The revision here is after the redefinition and revamping of the GDP series in July 2013. As an aside, the 2001 recession totally has disappeared from formal GDP reporting, thanks to revised statistical history.

The 4.3% peak-to-trough decline was worse than the revised 3.6% (previously 3.7%) contraction from August 1957 through April 1958, which involved a steel strike, but not by much, and worse than a revised 3.1% (previously 3.2%) contraction in the November 1973 to March 1975, which more commonly is viewed as the worst post-World War II recession prior to 2007. The 2007 recession also was declared the longest since the first down-leg of the Great Depression. The ShadowStats contention, though, remains that the 2007 downturn is ongoing and still is much deeper than has been indicated officially. This will be explored fully in the *Second Installment* (see also [Commentary No. 575](#)).

• Definitions of Broad Economic Activity:

Recession: Two or more consecutive quarters of contracting real (inflation-adjusted) GDP, where the downturn is not triggered by an exogenous factor such as a truckers’ strike. The NBER, which is the official arbiter of when the United States economy is in recession, attempts to refine its timing calls, on a monthly basis, through the use of economic series such as payroll employment and industrial production, and it no longer relies on the two quarters of contracting GDP rule.

Great Recession: A popularized term for describing the unusually-deep and protracted formal recession from December 2007 through June 2009, the most severe contraction in the U.S. economy since the Great Depression of the 1930s. The ShadowStats contention remains that the referenced downturn is ongoing and deeper than formally described.

Depression: A recession, where the peak-to-trough contraction in real growth exceeds 10%.

Great Depression: A depression, where the peak-to-trough contraction in real growth exceeds 25%.

Economic Recovery: The period following the trough of an economic downturn, once that “recovery” has exceeded the pre-recession or pre-downturn peak in activity, is considered recovery.

Once the economy is moving above its pre-recession high, it is in expansion, and a renewed downturn would be considered a new recession (a double-dip recession in the event of a particularly short-lived recovery). If the economy falters before regaining its pre-recession high, it remains in recession.

Economic Boom: Real year-to-year growth in the GDP exceeding 4% would be considered booming activity. Average annual growth in the last 40 years has been 2.7%. Average annualized quarter-to-quarter growth has been 2.8%, with any given quarter's annualized growth rate surrounded by a 95% confidence interval of +/- 3.5%.

Based on the preceding, there has been the one Great Depression, in the 1930s. Most of the economic contractions before that would be classified as depressions. All business downturns since World War II—as officially reported—have been recessions. Using a somewhat narrower “great depression” definition of a contraction in excess of 20% (instead of 25%), the depression of 1837 to 1843 would be considered “great,” as would be the wartime production shutdown in 1945.

As will be explored in the *Second Installment* of this hyperinflation series, the current downturn would qualify as a “depression” per the above definitions, and it should evolve into a “great depression,” as normal commercial activity grinds to a halt in a hyperinflation. Nonetheless, the term “Great Recession” has entered the popular lexicon for the current downturn. Given the financial pain that will be attributed to the Great Recession—if that terminology holds—those naming future such events likely will revert to “depression” usage or be looking to come up with a different descriptor for a “recession” in the post-collapse period.

Prior ShadowStats Hyperinflation Reports

Hyperinflation 2014—The End Game Begins is the sixth in a series of related writings going back to 2006. It updates and replaces [Hyperinflation 2012](#) of January 25, 2012, which preceded the introduction, expansion and “tapering” of the Federal Reserve’s QE3. It also preceded the 2012 presidential election and ensuing decline of public and global confidence in, and the functioning and stability of, the domestic political circumstance. Of particular issue for the global markets is the continuing political inability and unwillingness of the U.S. government to address its long-range sovereign-solvency issues. Still, the outlook has changed little. With the passage of 23 months since the last hyperinflation report, events just have continued to move this pending ultimate financial crisis into ever-closer time proximity. Interim, updated circumstances have been covered in the regular weekly Commentaries and particularly in [Commentary No. 577](#) (November 2013), [No. 527: Special Commentary](#) (May 2013), [No. 485: Special Commentary](#) (November 2012) and [No. 445: Special Commentary](#) (June 2012).

In turn, *Hyperinflation 2012* updated and replaced the [Hyperinflation Special Report \(2011\)](#) of March 15, 2011. It preceded: the U.S. government’s demonstration of a lack of political will to address the country’s long-range insolvency; the downgrade of the “AAA” rating of U.S. Treasury securities; an ensuing—albeit short-lived—U.S. dollar panic, dollar support operations and extremely unstable U.S. and global financial markets; a temporary shift in market focus to Euro-era issues; and growing recognition of the ongoing and deepening economic and systemic-solvency crises. Nonetheless, the outlook had changed little. With the passage of 10 months since the prior report (updated circumstances had been covered regularly in weekly *Commentaries*), events just had continued to move this pending ultimate financial crisis into much closer time proximity.

In turn, the 2011 report updated and replaced the [Hyperinflation Special Report \(2010 Update\)](#) of December 2, 2009, which preceded: the Fed's formal monetization of U.S. Treasury debt aimed at debasing the U.S. dollar; the sharpest post-World War II annual decline in broad money growth; the pronouncement of an official end to the 2007 recession despite no meaningful recovery; passage of the Administration's health insurance legislation; and the mid-term election. Yet, the outlook had changed little. With the passage of 15 months since the prior report (updated circumstances were covered regularly in weekly Commentaries), again, events just had moved the hyperinflation crisis into closer time proximity.

In turn, the 2010 report updated and replaced the [Hyperinflation Special Report](#) version of April 8, 2008, which was published post-Bear Stearns, but pre-Lehman, pre-TARP, pre-recession recognition and pre-2008 presidential election. The April 2008 report updated and expanded upon the three-part Hyperinflation Series that began with the [December 2006 SGS Newsletter](#), which predated public recognition of the 2007 economic and systemic-solvency crises.

Recommended Reading

As generally cited elsewhere in the text as *Foster*, and as recommended to subscribers for years, there is:

Fiat Paper Money, The History and Evolution of Our Currency

by Ralph T. Foster (Privately Published)

2189 Bancroft Way, Berkeley, CA 94704

E-mail: tfd@pacbell.net

To my knowledge, Ralph Foster's extraordinary volume is the most comprehensive and informative analysis available on the history of fiat currencies. This privately printed book continually is updated and expanded.

Chapter 1—Overview and Executive Summary

Where the underlying fundamentals have not changed, some text in this report has been repeated from the prior hyperinflation report. Nonetheless, all chapters include significant new text. Circumstances have continued to evolve towards an extreme inflation and economic crisis in the year ahead, with new developments and data covered as appropriate.

Monetary and Fiscal Crises Likely to Trigger Dollar Panic and Related Hyperinflation

Little has changed in the basic outlook for the 2014 onset of the Great Collapse, a hyperinflationary great depression. Extraordinary fiscal imbalances by 2004 had set the United States on course for a hyperinflation before the end of this decade. The Panic of 2008, and related extreme actions taken by the Federal Reserve and the U.S. government to prevent the collapse of the financial system, brought in the hyperinflation timing to 2014, which now is at hand.

A looming crisis in the U.S. dollar—a panicked sell-off in the U.S. currency in the months ahead—remains the likely proximal trigger for the early stages of the hyperinflation. A sharp decline in the exchange-rate value of the dollar (all dollar references are for the U.S. dollar, unless otherwise noted) would spike dollar-denominated commodity prices, such as oil, and related inflation.

Generally, there are two types of inflation, demand-pull and cost-push. Demand-pull is the happier version, driven by strong demand, which exceeds supply, pulling prices and economic activity higher.

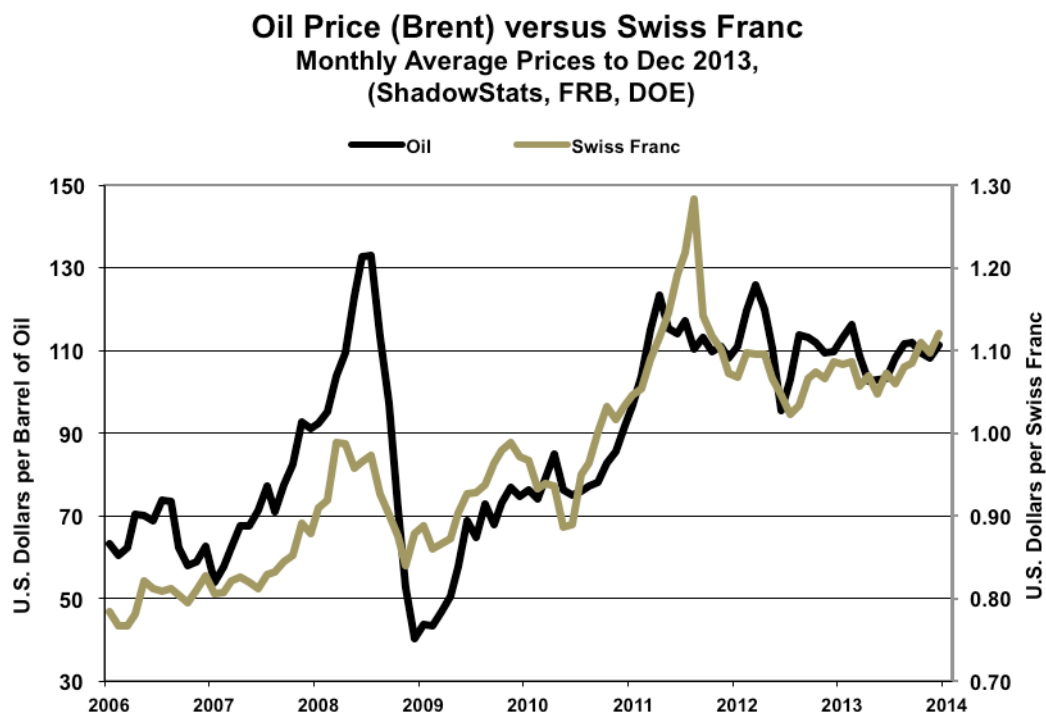
In contrast, commodity prices, pushed higher by a weakened dollar, would drive an initial cost-push inflation. Under this circumstance, higher inflation usually is seen without strong economic activity. For example, in recent years, monetary policies of the Fed—aimed at dollar debasement—weakened the U.S. currency, which, in turn boosted oil prices. In turn, gasoline prices rose due to monetary/currency distortions, not due to strengthening demand. Where gasoline is a necessity for many, and where consumer income and liquidity otherwise were structurally impaired, some of the higher spending dedicated to gasoline consumption had to be offset by spending cuts in other areas.

Weakening Dollar Spikes Oil and Domestic Inflation

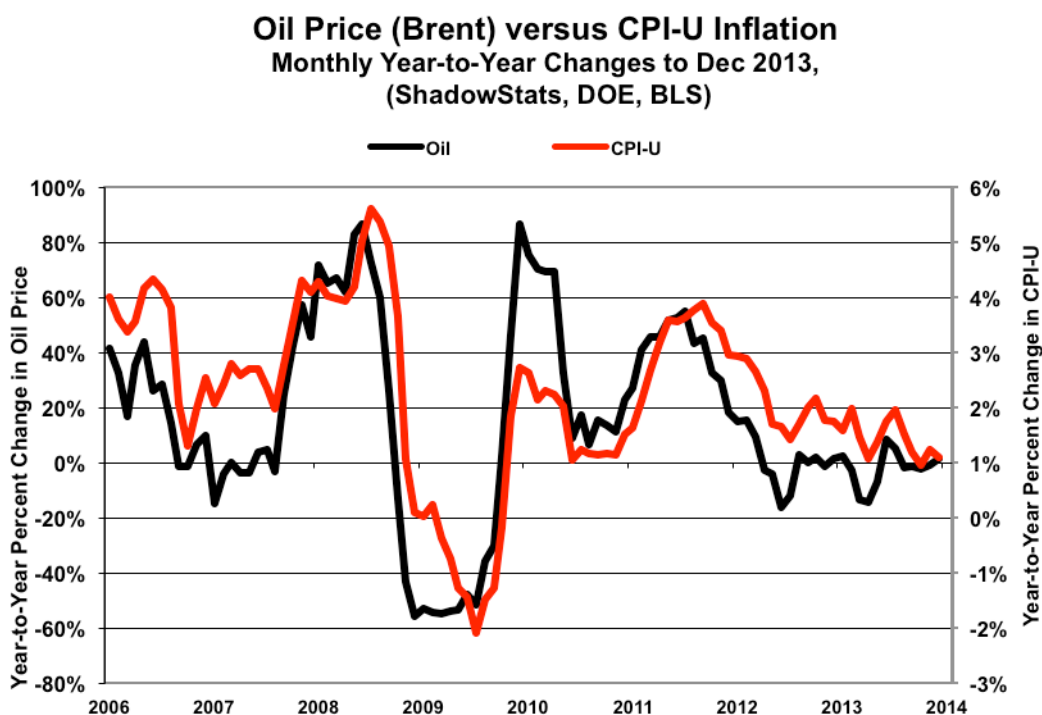
Denominated in the U.S. dollar, the price of oil in the global markets moves with an inverse relationship to the exchange-rate value of the dollar. Where the price of oil can gyrate wildly—tied to supply and demand concerns and disruptions, and to related political circumstances in the Middle East and among OPEC members—the changes in the exchange-rate value of the U.S. dollar still account for 80% of the movement in oil prices. As shown in *Graph 3* of the average monthly oil price (Brent) versus the Swiss franc in dollars, the weaker the dollar (the stronger the Swiss franc), the stronger will be the price of oil.

In turn, changes in oil prices are the dominant component of cost-push inflation in the United States. As shown in *Graph 4*, the year-to-year changes in the price of oil and CPI inflation also move together 80% of the time.

Graph 3: Oil Prices versus Swiss Francs, Both Valued in U.S. Dollars



Graph 4: Year-to-Year Change in Oil Prices versus U.S. CPI-U Annual Inflation



Confluence of Crises Set Against the U.S. Dollar

If initial weakness in the U.S. dollar is not part of a currency-selling panic, it likely will cascade into one, with domestic and global holders of the U.S. currency dumping it and related dollar-denominated paper assets as quickly as possible. Cash and liquid, dollar-denominated paper assets are an effective overhang to the domestic U.S. money supply of more than \$16 trillion. In contrast, broad money (ShadowStats-Ongoing M3) stood at about \$15.5 trillion in December 2013. In response, the Federal Reserve would be forced to attempt to stabilize the domestic financial markets, including massive monetization of unwanted U.S. Treasury debt. The resulting surge in the money supply, combined with the cost-push pressures from the sinking dollar, would trigger the early phase of a hyperinflation. Coincident with and likely exacerbating that crisis would be the loss of the dollar's reserve status.

In turn, as the early stages of runaway inflation hit an economic system unprepared and unstructured for such activity, the hyperinflation would tend to disrupt the normal flow of commerce, pushing an already-depressed and faltering economy into great-depression territory, hence the forecast of a hyperinflationary great depression.

The unfolding circumstance will encompass a complete loss U.S. dollar purchasing power; extreme disruption in the normal stream of U.S. commercial and economic activity; a collapse in the U.S. financial system; and a likely realignment of the U.S. political environment (see *Chapter 5*).

A confluence of four primary, systemic instabilities underlie the unfolding crisis of confidence and looming selling panic in the U.S. dollar. On a relative basis, each circumstance is worse than any parallel issues seen with the other major Western currencies. Individually, any one of these circumstances has the potential for triggering a dollar sell-off:

- Unwillingness of the U.S. government to address its sovereign-solvency issues, as the circumstance spins out of control (see *Chapter 5*).
- Extreme monetary actions from the Fed, aimed at monetizing Treasury debt (debasement of the dollar) and ultimately at stabilizing a still-impaired financial system (see *Chapter 4*).
- Severely damaged economic activity, which never recovered from its collapse into 2009 and has started to turn down anew (extensive coverage in *Second Installment*).
- Crisis of confidence in a dysfunctional federal government.

Fiscal Crisis. The financial statements of the United States government, prepared using generally accepted accounting principles (GAAP), published by the U.S. Treasury and audited by the GAO, show the actual annual federal deficit running in excess of \$6 trillion per year, with total U.S. financial obligations in excess of \$90 trillion, as discussed in *Chapter 5*.

GAAP-accounting for the government's unfunded liabilities reflects net-present-value (NPV), where the stream of unfunded obligations into the future is discounted for the time-value of money. Effectively, NPV is the amount of interest-bearing funds needed in hand, today, to cover future obligations as they become due.

As of September 30, 2013 (end of the government's fiscal year), the total value of federal obligations—including gross federal debt and the NPV of the unfunded liabilities for underfunded programs such as Social Security—was a record \$92.3 trillion. With roughly \$75 trillion of that total in unfunded

liabilities, the U.S. would have to set aside \$75 trillion, in hand, today, to maintain the long-term solvency of the country. With nominal (not-adjusted-for-inflation) U.S. GDP at \$16.6 trillion for fiscal-year 2013, and with September 2013 M3 at \$15.4 trillion, setting aside such an amount is physically impossible, shy of a hyper-inflating Federal Reserve.

A common question regarding the ratio of total obligations versus GDP is how the U.S. ratio compares with other countries. The general answer, as best I can determine it, is that the U.S. has the highest ratio of total obligations (including NPV of unfunded liabilities) to GDP of any country or region tied to the seven most-widely trade currencies: U.S. dollar, euro, yen, pound, Swiss franc, Australian dollar and the Canadian dollar. It is difficult, however, to get consistent numbers and definitions for comparison purposes (see *Chapter 5*).

Deficit negotiators lost the confidence of the global markets in 2011, as unresolved sovereign-solvency issues were pushed off into the future (a pattern that keeps getting repeated), in conjunction with a sovereign rating downgrade for the United States.

Where recent negotiations resulted in agreements on the 2014 and 2015 federal budgets, those controlling the U.S. government again demonstrated a lack of ability and political will to address the longer-term solvency issues facing the United States. There was an attempt there to push off such issues until after 2014 mid-term election, but chances that the global markets will give the United States that leeway are close to nil.

Monetary Crisis. Crises continue in U.S. financial-system solvency, as suggested by indications of mounting banking-system stress and the ongoing quantitative easing by the Federal Reserve, which continues to flood the banking system with unprecedented levels of liquidity, along with significant monetization of U.S. Treasury debt. The Fed monetized 72% of 2014 net issuance of Treasury debt held by the public.

As discussed in *Chapter 4*, the Fed's extraordinary easing in QE3 continues, despite a recent, minor "tapering" move, which likely was no more than political window dressing for the benefit of incoming Fed Chairman Janet Yellen. She is expected to continue current Fed Chairman Ben Bernanke's dollar-debasement policies, in conjunction with addressing ongoing systemic stresses.

The Fed's primary function is to support the banking system, not the economy. As was seen in 2008, it will do everything in its power to prevent a collapse in the financial system. The excessive liquidity from QE3 is being used to prop up the banks. QE3 should continue and/or be increased in the foreseeable future, using the ongoing political cover of a weak economy. The Fed admits that it has no monetary tools available, at present to boost economic activity.

Economic Crisis (Including Trade Deficit). Broad U.S. economic activity has begun to turn down anew, never having recovered from its collapse into 2009. Continuing structural income and liquidity problems have impaired consumer ability to fuel an economic rebound. Separately, the U.S. trade deficit remains the largest in the world and an ongoing drag on the value of the dollar. Two summary graphs on the economy follow in this chapter, but the *Second Installment* will provide extended coverage of the U.S. economy, both in terms of background to the current environment and in terms of possible economic conditions going forward.

Crisis of Confidence in the U.S. Government. An important variable in the assessment of any currency's value is the relative political stability of its government. The approval rating of the U.S. President has served as a surrogate indicator for that variable, over time, and that indicator is about as weak now as it ever has been. Circumstances in the months ahead are likely to dampen, not improve, the public's mood.

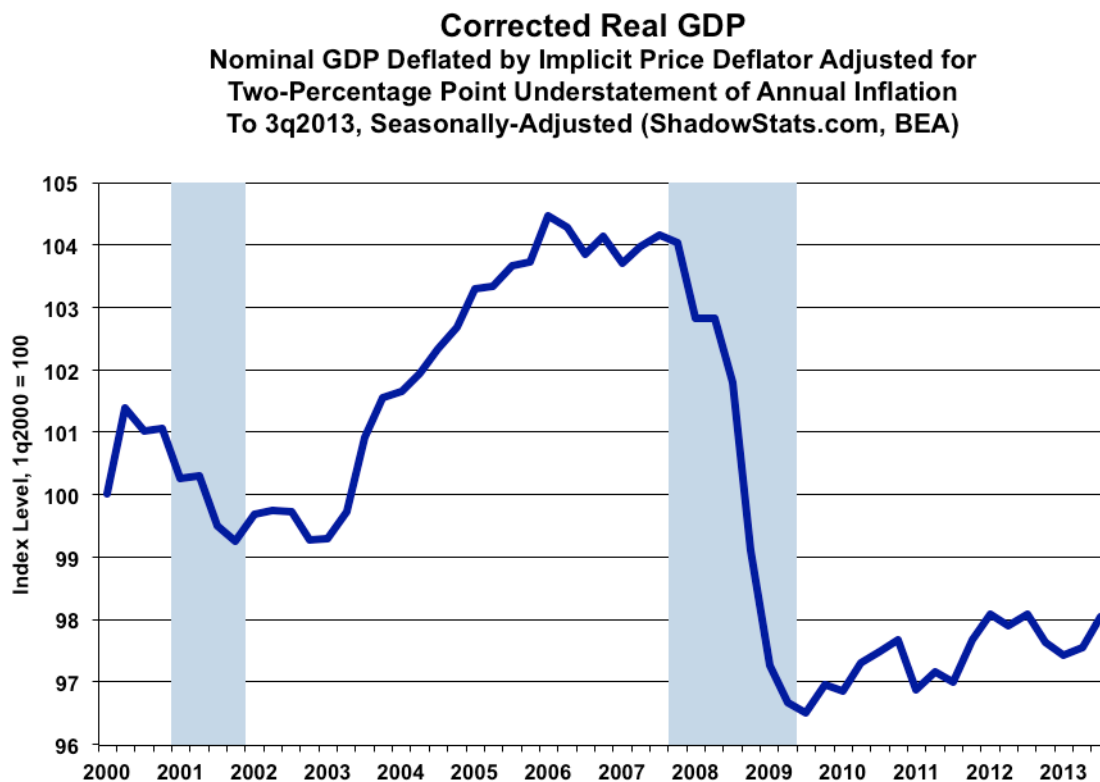
U.S. Economy Has Not Recovered and Is Turning Down Anew

U.S. business activity appears to have turned down anew, in what likely will gain formal recognition as a new recession, or the second-dip of a double-dip recession. The general outlook for the economy will be covered in greater detail in the *Second Installment*, but the following summary and graphs offer some of the basic concepts.

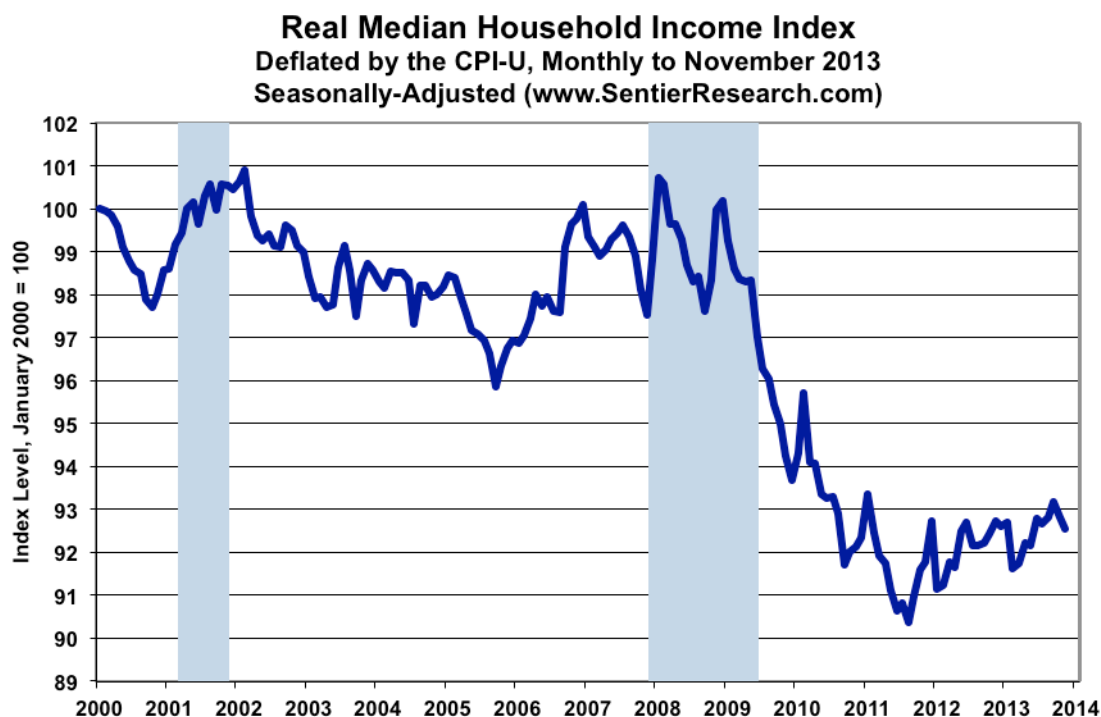
The official version of recent economic history is that the economy peaked and began to turn down in fourth-quarter 2007, with activity plunging through 2008 and the recession ending in June 2009. Economic activity fully recovered thereafter, and a new and healthy economic expansion has been in place since second-quarter 2011. The official recovery is a statistical fantasy generated by the use of understated inflation in deflating the GDP, which results in overstated inflation-adjusted growth.

Instead of plunge and recovery, the ShadowStats version is one of plunge and protracted stagnation, with activity that never recovered and that has started to turn down anew, although that detail is not reflected fully, yet, in the “corrected” GDP reporting of *Graph 5*.

Graph 5: Economic Plunge and Stagnation in Corrected Real GDP



Graph 6: Real Median Household Income, Monthly 2000 to November 2013



November 2013 real (inflation-adjusted) median household income remained stagnant, near its cycle low, with the series pretty much having plunged in tandem with the “corrected” GDP graph. The latest data are courtesy of www.SentierResearch.com. Based on Census Bureau annual reporting, the income numbers are near levels seen in the late-1960s, early-1970s.

Without growth in real income or credit, and given levels of consumer confidence that remain deep in traditional recession territory, the U.S. consumer has not been able to fuel an economic recovery, and no rebound appears to be in the works.

Time for Substantive Government-Corrective Actions Has Passed

With no viable or politically-practical way of balancing U.S. fiscal conditions or stabilizing the financial system—avoiding this financial and economic Armageddon—the best action that individuals can take at this point remains to protect themselves, both as to meeting short-range survival needs, as well as to preserving current wealth and assets over the longer term. Efforts there, respectively, would encompass building a store of key consumables, such as food and water, and moving assets into physical precious metals and outside of the U.S. dollar.

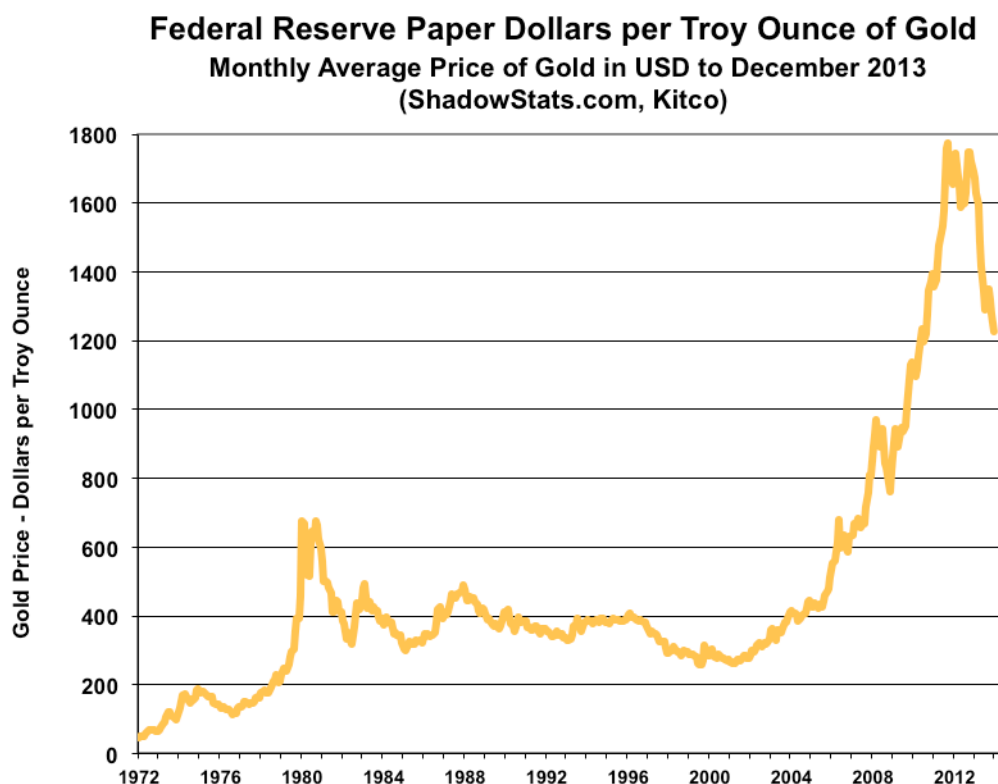
If the regular flow of commerce is disrupted, having a store of basic necessities to draw upon is common sense. Hyperinflation would destroy the purchasing power of the U.S. dollar. Where physical gold and silver act as stores of wealth, they remain the primary hedges against the ultimate dollar debasement. Various options will be explored and updated in the *Second Installment*, but, again, the basics of potential personal actions and a variety of potential government and regulatory reactions to the crisis already are covered in [Hyperinflation 2012](#).

Central Bank Interventions Depressed Gold and Propped U.S. Dollar, Stocks and Bonds

Speculations aside as to potential government and Federal Reserve actions in response to the developing crises, significant market interventions already have been evident in the last year or so. In particular, there is no secret as to the Administration or Fed's disdain for gold's popularity in recent years. Soaring gold prices suggest that the government and central bank are not doing their jobs in maintaining current or prospective systemic or price stability. The strong rally in the price of gold into 2013, as shown in *Graph 7*, was fundamentally driven. Heavy selling in the last year was influenced and exacerbated by orchestrated intervention.

A number of times, very large sell-orders, from one customer, were placed in the global markets before the open of U.S. trading. For someone looking to move out of gold, orderly sales would make the most sense in terms of getting the best prices. Instead, these actions were designed to pummel the gold markets, and they did.

Graph 7: Federal Reserve Notes per Ounce of Gold



Nonetheless, for those holding gold as a hedge against the debasement of the dollar, the hedging does not work unless it is held in place. Whether gold is purchased at \$1,000, \$2,000 or \$5,000 an ounce does not make that much difference. When gold hits \$100,000 an ounce, it will be proving its worth, but until the hyperinflation is over, or the value of the gold is transferred to some other hard asset, “taking profits” in the traditional manner does not make sense. Gold at \$100,000 an ounce likely still will be reflecting something close to the purchasing power of the currency that was put into it, stabilizing the

value of the involved assets. That would be true as well at \$1,000,000 per ounce or \$1,000,000,000 per ounce, wherever the currency debasement takes it.

Fed jawboning on its quantitative easing options also has been used to impact the value of gold, the dollar, equities and the credit markets. The President's Working Group on the Markets (a.k.a. the Plunge Protection Team), headed by the Fed Chairman has had its impact as well. Some actions in the equity markets, such as in advance of the U.S. sovereign rating downgrade, were obvious. Activity here usually is not advertised, although Alan Greenspan once mentioned how interventions in the oil, gold, currency, credit and equity markets all had been seen in one incident in involving Iraq.

Day of Reckoning at Hand

Purportedly, it was Arthur Burns, Fed Chairman under Richard Nixon, who first offered the advice that helped to guide a number of Administrations. The gist of the imparted wisdom was that if the Fed or federal government ran into economic or financial-system difficulties, the federal budget deficit and the U.S. dollar simply could be ignored—or sacrificed. Ignoring them would not matter, it was argued, because doing so would not cost the incumbent powers any votes.

Based on an \$11 trillion surge in 2004 unfunded liabilities, I raised the issue of an inevitable U.S. hyperinflation with an advisor to both the Bush Administration and Fed Chairman Greenspan. I was told simply that, "It's too far into the future to worry about."

Indeed, attempting to push the big problems further into the future continues to be the working strategy for the Fed, the current Administration and Congress.

In a February 25, 2011 speech, Federal Reserve Vice Chairman Janet Yellen examined the results of the recent use of "unconventional policy tools" by the Fed: "Each of these policy tools tends to generate spillovers to other financial markets, such as boosting stock prices and putting moderate downward pressure on the foreign exchange value of the dollar."

While Wall Street may hail any artificial propping it can get from the Fed's efforts to support the markets, more than "moderate" related declines in the U.S. dollar's exchange rate destroy any illusions of stock gains, and savage the U.S. consumers' dollar purchasing power. A declining dollar can turn U.S. stock profits into losses for those living outside the dollar-denominated world, as funds are converted back to the strengthening currency domestic to the investor. Inflation driven by dollar weakness will do the same for those in a U.S. dollar-denominated environment, where, eventually, inflation can turn U.S. stock profits into real inflation-adjusted losses.

Indeed, the U.S. dollar and the budget deficit do matter, and the future is at hand. As the federal budget deficit spirals well beyond sustainability and containment, at an accelerating pace, as the Fed moves with great deliberation to flood the system with liquidity and to monetize significant amounts of Treasury debt, and as global markets look to escape looming losses in U.S. dollar holdings, the day of ultimate reckoning for the U.S. currency appears to be breaking.

Chapter 2—Two Examples of Hyperinflation

Some Lessons from History

Ralph T. Foster's *Fiat Paper Money* (see *Recommended Reading*, page 11) details the history of fiat paper currencies from 11th Century Szechwan, China, to date. He recounts the consistent collapse of those currencies, time-after-time, due to what appears to be the inevitable, irresistible urge of those issuing a currency to print too much of a good thing. The United States is no exception, already having obligated itself to liabilities in excess of \$90 trillion, well beyond its ability ever to pay off. Those obligations continue to grow by more than \$6 trillion per year, while the currency printing presses are running overtime in conjunction with heavy Federal Reserve monetization of U.S. Treasury debt.

Among numerous instances of hyperinflation in the last one hundred years, two are highlighted here. First, the Weimar Republic hyperinflation of the early 1920s is close enough to what is envisioned for the United States so as to provide some cautions as to the scope of the runaway inflation. Second, the Zimbabwe hyperinflation in the first decade of the 21st Century provides an example of an economy continuing to function, at least temporarily, through such a currency crisis, thanks to functioning black markets. The United States does not have a back-up system for its currency, black market or otherwise.

Weimar Republic

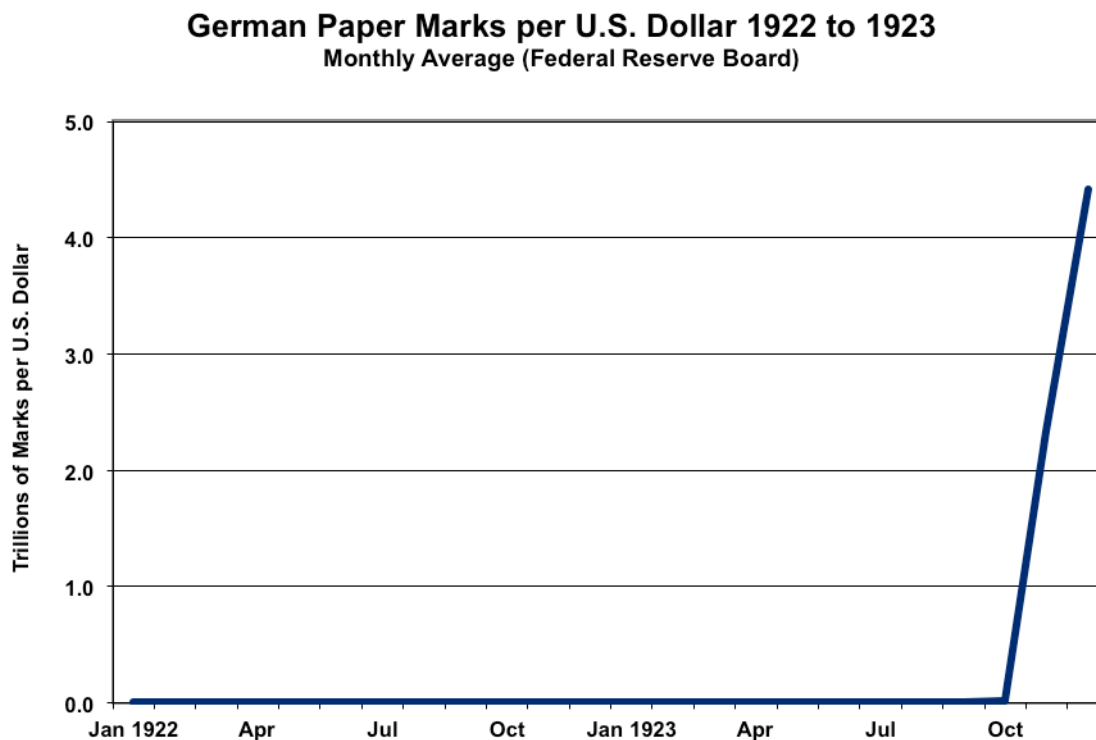
Foster closes his book's preface with a particularly poignant quote from a 1993 interview of Friedrich Kessler (1901-1998), a law professor whose university affiliations included, among others, Yale and the University of California Berkeley. From firsthand experience, Kessler described the Weimar Republic hyperinflation:

"It was horrible. Horrible! Like lightning it struck. No one was prepared. You cannot imagine the rapidity with which the whole thing happened. The shelves in the grocery stores were empty. You could buy nothing with your paper money."

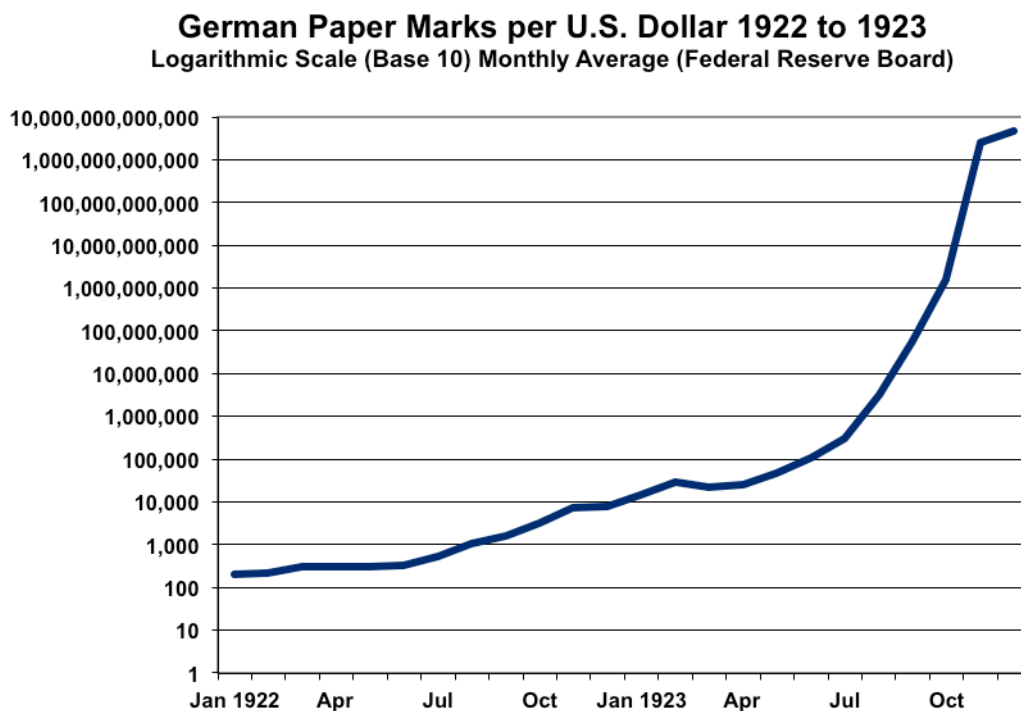
Some anecdotes—as to the pace of hyperinflation of Germany's Weimar Republic—involved eating and drinking. At one point in the crisis, someone planning lunch in a restaurant commonly would negotiate a price and pay in advance for the meal, since the price otherwise would be higher after lunch. Another person could have an expensive bottle of wine with dinner. By the next morning, the empty wine bottle would be worth more as scrap glass than it had been worth the night before as an unopened bottle of fine wine.

The following two graphs plot the same numbers, but on different scales. The data are the monthly averages of the number of paper German marks that equaled one dollar (gold-backed) in 1922 and 1923, with that number acting as something of a surrogate for the pace of inflation.

Graph 8: German Paper Marks per U.S. Dollar 1922 to 1923



Graph 9: Log Scale, German Paper Marks per U.S. Dollar 1922 to 1923



Graph 8 is a simple arithmetic plot, but the earlier detail is masked by the extreme numbers of the final several months, suggestive of the extraordinarily rapid and large rise in the pace of inflation. The second plot, *Graph 9*, is on a logarithmic scale, where each successive power of ten represents the next tick mark on the vertical scale. While the hyperinflation did hit rapidly, annual inflation in January 1922 already was more than 200%, up from as low as 6% in April 1921. The existing currency was abandoned at the end of 1923.

Milton Friedman and Anna Jacobson Schwartz noted in their classic *A Monetary History of the United States* that the early stages of the Weimar Republic hyperinflation was accompanied by a huge influx of foreign capital, much as had happened during the U.S. Civil War. The speculative influx of capital into the U.S. at the time of the Civil War inflation helped to stabilize the system, as the foreign capital influx into the U.S. in recent years had helped to provide relative stability and strength to the equity and credit markets. Following the Civil War, however, the underlying U.S. economy had significant untapped potential and was able to generate strong, real economic activity that covered the war's spending excesses.

Post-World War I Germany was a different matter, where the country was financially and economically depleted as a penalty for losing the war. Here, after initial benefit, the influx of foreign capital helped to destabilize the system. "As the mark depreciated, foreigners at first were persuaded that it would subsequently appreciate and so bought a large volume of mark assets..." Such boosted the foreign exchange value of the German mark and the value of German assets. "As the German inflation went on, expectations were reversed, the inflow of capital was replaced by an outflow, and the mark depreciated more rapidly... (*Friedman p. 76*)."

Indeed, in the wake of its defeat in the Great War, Germany was forced to make debilitating reparations to the victors—particularly France—as well as to face loss of territory. From *Foster-Chapter 11*:

"By late 1922, the German government could no longer afford to make reparations payments. Indignant, the French invaded the Ruhr Valley to take over the production of iron and coal (commodities used for reparations). In response, the German government encouraged its workers to go on strike. An additional issue of paper money was authorized to sustain the economy during the crisis. Sensing trouble, foreign investors abruptly withdrew their investments.

"During the first few months of 1923, prices climbed astronomically higher, with no end in sight... The nation was effectively shut down by currency collapse. Mailing a letter in late 1923 cost 21,500,000,000 marks."

The worthless paper German mark became useful as wallpaper and toilet paper, as well as for stoking fires. As seen in Germany, the normal flow of commerce in the United States also likely would be shut down.

The Weimar circumstance, and its heavy reliance on foreign investment, was closer to the current U.S. situation than it was to the U.S. Civil War experience. In certain aspects, the current U.S. situation is even worse than the Weimar situation, where the U.S. crisis has been self-imposed and it involves the world's reserve currency. It certainly is worse than the Civil war circumstance.

Unlike the still largely untapped economic potential of the United States 149 years ago, today's U.S. economy is languishing in the structural problems of the loss of its manufacturing base and a shift of

domestic wealth offshore; it is mired in an economic contraction that is immune to traditional economic stimuli. As the U.S. government attempted in recent decades to assuage electorate discontent with ever more expensive social programs; as the Federal Reserve moved to encourage debt expansion as a remedy for lack of real, inflation-adjusted, income growth; the eventual bankruptcy of the U.S. dollar was locked in. The problem here was taken on and created willingly by U.S. government officials—embraced by both major political parties—not imposed by a victorious and vengeful enemy of war.

Again, in the early 1920s, foreign investors in Germany were not propping up the world's reserve currency (then the pound sterling) in an effort to prevent a global financial collapse, and they did not know in advance that they were doomed to take a large hit on their German investments. In today's environment, both central banks and major private investors know that the U.S. dollar is a losing proposition. They either expect and/or hope that they can get out of the dollar in time to avoid more-severe losses than already taken, or, in the case of the central banks, that they can forestall the ultimate global economic crisis. Such expectations and hopes have dimmed markedly in the last several years, as the untenable U.S. fiscal condition has gained much broader public and global recognition. When the U.S. dollar loses its reserve status, the pace of the debasement should accelerate rapidly.

Zimbabwe

Hyperinflation in Zimbabwe, the former Rhodesia, was a quadrillion times worse than it was in Weimar Germany. Zimbabwe went through a number of years of high inflation, with an accelerating hyperinflation from 2006 to 2009, when the currency was abandoned. Through three devaluations, excess zeros repeatedly were lopped off notes as high as 100 trillion Zimbabwe dollars.

Image 1: \$100,000,000,000,000 Zimbabwe Note



The cumulative devaluation of the Zimbabwe dollar was such that a stack of 100,000,000,000,000,000,000,000 (26 zeros) two dollar bills (if they were printed) in the peak hyperinflation would have been needed to equal in value what a single original Zimbabwe two-dollar bill

of 1978 had been worth. Such a pile of bills literally would be light years high, stretching from the Earth to the Andromeda Galaxy.

In early-2009, the governor of the Zimbabwe Reserve Bank indicated he felt his actions in printing money were vindicated by the then recent actions of the U.S. Federal Reserve. If the U.S. went through a hyperinflation like that of Zimbabwe's, total current U.S. federal debt and obligations (more than \$90 trillion with unfunded liabilities) could be paid off for much less than a current U.S. penny.

This sign in a restroom facility at a South African border station with Zimbabwe speaks for itself.

Image 2: Toilet Sign Cautioning Against Use of Zimbabwe Dollars



What helped to enable the evolution of the Zimbabwe monetary excesses over several years, while still allowing some temporary semblance of economic activity, was the backup of a well-functioning black market in U.S. dollars. Someone being paid in Zimbabwe dollars would look to stabilize the purchasing power of the currency in hand, exchanging it as soon as possible for U.S. dollars in that black market. Otherwise, the purchasing power of any retained Zimbabwe dollars could deteriorate meaningfully in hours. The U.S. dollars acted as a hard asset, as a store of wealth for the holders of Zimbabwe dollars, permitting more-orderly purchases of food, payment of rent, etc.

At present, the United States has no such backup system, with implications for a more rapid and disruptive hyperinflation, when it hits, than was seen in Zimbabwe. With no backstop to the continuously depreciating U.S. dollar, domestic commerce quickly would tend to cease. While a barter system likely would evolve, such would require some time to get organized and to operate smoothly.

As will be discussed in the *Second Installment*, former Congressman Ron Paul introduced legislation that would have made physical gold and silver legal tender in the United States, freely exchangeable

with Federal Reserve notes, at the going exchange rate of open-market gold and silver prices, without tax consequence. That would have provided the potential backup and stability needed to mitigate the economic devastation of the head-on impact of hyperinflation with the U.S. economy. Anyone receiving payment in the rapidly depreciating dollar would be able to exchange those dollars for gold or silver, effectively stabilizing the purchasing power of the just-received, debased currency.

Utah and Arizona have enacted legislation along the lines proposed by Ron Paul, and a number of states are considering same, but federal legislation is needed for the approach to mitigate hyperinflation's devastating economic impact on a broad scale.

Chapter 3—Historical U.S. Inflation and U.S. Dollar Debasement

Fire and Ice

Some say the world will end in fire,
Some say in ice.
From what I've tasted of desire
I hold with those who favor fire.
But if it had to perish twice,
I think I know enough of hate
To say that for destruction ice
Is also great
And would suffice.

– Robert Frost

As to the fate of the developing U.S. great depression, it will encompass the fire of a hyperinflation, instead of the ice of deflation seen in the major U.S. depressions prior to World War II. What promises hyperinflation this time is the lack of monetary discipline formerly imposed on the system by the gold standard; a fiscally bankrupt federal government; and a Federal Reserve dedicated to debasing the U.S. dollar and to preventing a banking system collapse at all costs.

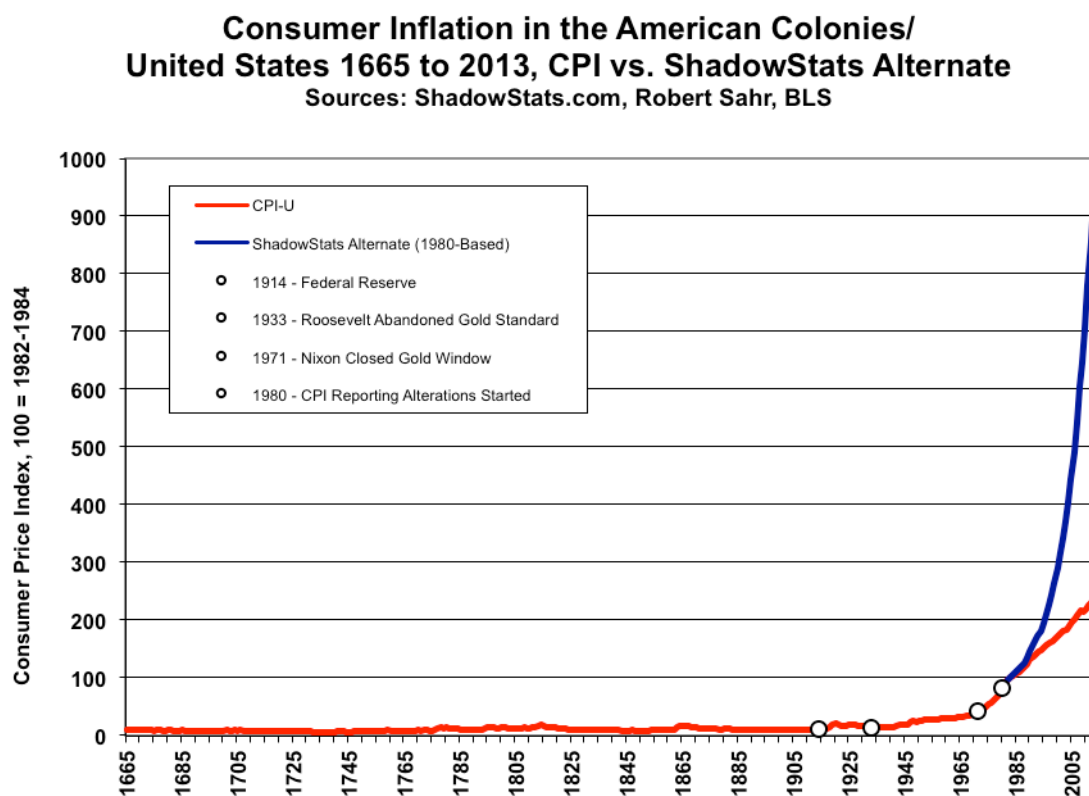
Both the federal government and the Federal Reserve demonstrated in 2008, and in the months and years following, that they would not tolerate a systemic collapse and a possible great deflation, as seen during the Great Depression. Those risks still are being fought, and will be fought at any cost that can be covered by whatever money, spending, lending, financial guarantees or other financial interventions as needed.

Those extreme systemic interventions and formal measures to debase the U.S. dollar through the effective unlimited creation of money (quantitative easing involves the Federal Reserve's direct creation of money through the monetization of U.S. Treasury debt), aimed at covering financial-system solvency and the government's obligations, pushed the timing of a systemic collapse—threatened in September 2008—into the future. The cost of instant, as well as ongoing, systemic salvation, though, is eventual inflation. It was a devil's choice, but the choice was made. The inflation-versus-deflation debate is discussed in detail in *Chapter 4—Federal Reserve, Systemic Solvency, and Inflation versus Deflation*.

Ongoing stagnation/deterioration in the economy, combined with those various financial distortions to the system, including crises-based monetary and fiscal policies, have created a confluence of elements that will pummel the U.S. dollar against other currencies in the year ahead. That circumstance should evolve into the proximal trigger for the hyperinflation. Systemic collapse is unavoidable at this point, but it will be in a hyperinflationary great depression, instead of a deflationary one. A direct result of Fed and U.S. government efforts to delay systemic collapse, as long as possible, the hyperinflation will have been born beyond the reach of official containment, the child of last-ditch efforts to salvage a system that had been methodically pushed into long-range insolvency by decades of political and policy malfeasance by the federal government and Federal Reserve.

Putting the current environment in historical perspective, the following two graphs measure the level of consumer prices since 1665 in the American Colonies and later the United States. The first, *Graph 10*, shows what appears to be a fairly stable level of prices up to the founding of the Federal Reserve in 1913 (began activity in 1914) and to Franklin Roosevelt's abandoning of the domestic gold standard in 1933. Then, inflation takes off in a manner not seen in the prior 250 years, and at an exponential rate when viewed using the ShadowStats-Alternate Measure of Consumer Prices in the last several decades (see [Public Comment on Inflation](#)). The price levels shown prior to 1913 were constructed by Robert Sahr of Oregon State University. Price levels since 1913 either are Bureau of Labor Statistics (BLS) or ShadowStats-based, as indicated.

Graph 10: Consumer Inflation 1665 to 2013

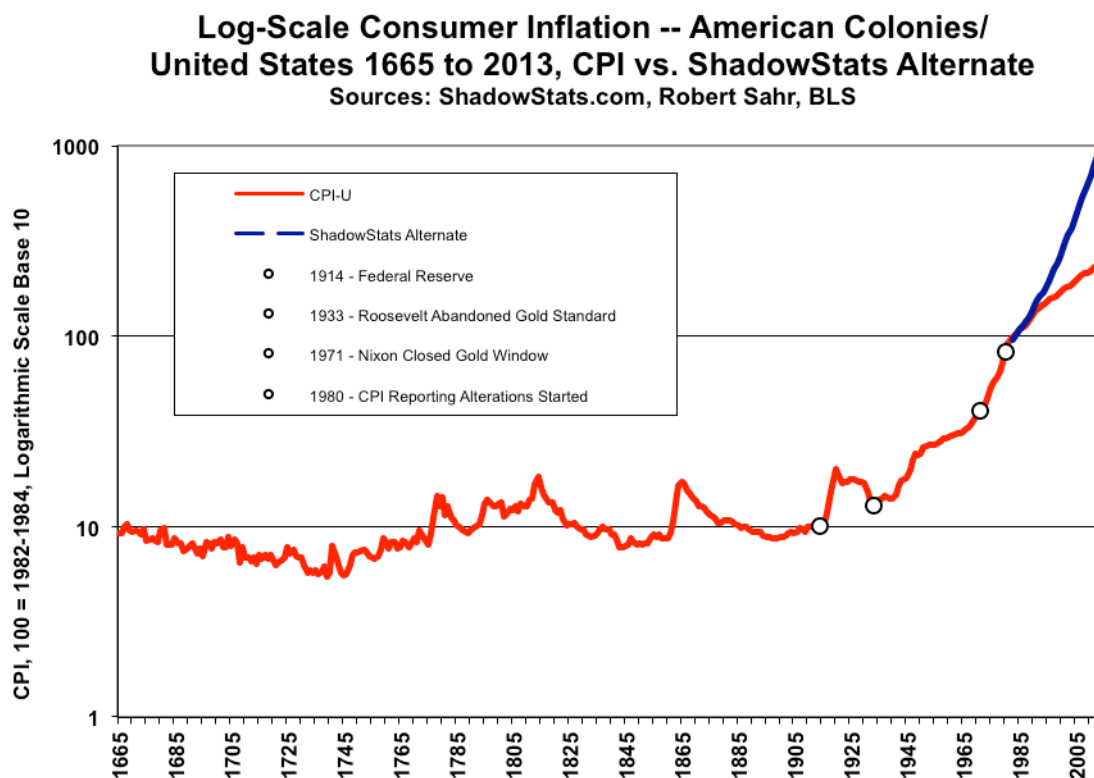


The magnitude of the increase in price levels in the last 50 years or so, however, visually masks the inflation volatility of the earlier years. That early volatility becomes evident in the next graph, where the CPI history is plotted using a logarithmic scale. Seeing such detail is a particular benefit of using such a plot, although the full scope of what is happening may be lost to those not used to thinking log-based. The pattern of the rising CPI level, however, still looks rather frightening even in the modified form. Nonetheless, since inflation ideally is something that is flat over time—not compounding like the population and related series that grow with it—I do not have any issue with using a non-log scale for the visual impact of what is happening.

Persistent year-to-year inflation (and the related compounding effect) did not take hold until post-Franklin D. Roosevelt. Additionally, the CPI level reflects purchasing power lost over time for those holding dollars, which is cumulative, and which has reached extremes (as will be discussed shortly) due to the late-era compounding effect. If the ShadowStats assessment is correct on where this is headed, the log-based graph shortly will look like the arithmetic-based graph, as was seen the latter months of the Weimar circumstance and as shown in the *Weimer Republic* section in *Chapter 2*.

Indicated by the visible detail in *Graph 11* are the regular periods of inflation—usually seen around wars—offset by periods of deflation, up through the Great Depression. Particular inflation spikes can be seen at the time of the American Revolution, the War of 1812, the Civil War, World War I and World War II (which lacked an ensuing, offsetting deflation). As a result, consumer prices at the time of the Fed’s founding in 1913 were about the same as they had been in New Amsterdam (today’s New York City) in 1665.

Graph 11: Log-Scale Consumer Inflation 1665 to 2013



The inflation peaks and the ensuing post-war depressions and deflationary periods, tied to the War of 1812, the Civil War and World War I, show close to 60-year cycles, which is part of the reason some economists and analysts have been expecting a deflationary depression in the current period. There is some reason behind 30- and 60-year financial and business cycles, as the average difference in generations in the United States is 30 years, going back to the 1600s. Accordingly, it seems to take two generations to forget and repeat the mistakes of one's grandparents. Similar reasoning accounts for other cycles that tend to run in multiples of 30 years.

Allowing for minor, average-annual price-level declines in 1949, 1955 and 2009, the United States has not seen a major deflationary period in consumer prices since before World War II. The reason for this is the same as to why there has not been a formal depression since before World War II: the abandonment of the gold standard and recognition by the Federal Reserve of the impact of monetary policy—free of gold-standard system restraints—on the economy.

Abandoning Gold

The gold standard was a system that automatically imposed and maintained monetary discipline. Excesses in one period would be followed by a flight of gold from the system and a resulting contraction in the money supply, economic activity and prices.

Faced with the Great Depression, and unable to stimulate the economy due largely to the monetary discipline imposed by the gold standard, President Franklin Roosevelt used that circumstance as an excuse to abandon the domestic gold standard. He adopted close to a fully-fiat currency, under the auspices of what could be called the “debt standard,” where the government effectively could print and spend whatever money it wanted to create. The issues here will be expanded upon in the *Second Installment*.

Roosevelt's actions were against the backdrop of the banking system being in a state of collapse. There was no deposit insurance at the time, and available Federal Reserve policies were ineffective, as banks failed and the money supply imploded. A depression collapsed into the Great Depression, with intensified consumer price deflation. Importantly, a sharp decline in broad money supply is a prerequisite to significant goods-and-services price deflation.

Messrs Greenspan and Bernanke both were students of the Great Depression period. As did Mr. Greenspan before him, “Helicopter Ben” vowed not to allow a repeat of the 1930s money supply collapse and a resulting severe deflation (see *Chapter 4*). Incoming Fed Chairman Janet Yellen purportedly is in Mr. Bernanke's camp.

Where Roosevelt abandoned the gold standard and its financial discipline for the debt standard, twelve successive administrations have pushed the debt standard to the limits of its viability, as seen now in the current economic and systemic turmoil, and in the ongoing threat of systemic collapse.

In the latest budget negotiations, the current Administration and those controlling Congress demonstrated their continuing lack of ability and lack of political willingness to address the nation's long-range solvency problems. They also attempted to push off the day of reckoning for fiscal imbalances until after the 2014 midterm election, but they do not have that much time. The U.S. financial system and economy already have been pushed to their limits, with resulting crashes and pending collapse.

No Way Out

Where President Roosevelt had the option of changing the system to address his crises, abandoning the gold standard and embracing the open creation of new money with the expansion federal debt, there is no place for the current Administration to go. There are no alternatives to the current system that would enable the government and the Federal Reserve to continue pushing their problems into the future. There is no gold standard to abandon.

For decades, going no further than the shortsighted political self-interests of those running the system, the government and the Fed borrowed excessive economic growth and prosperity from the future, knowing that eventually there would a time for payback. That day-of-reckoning is at hand.

While bringing the financial system into fiscal balance would have meant some financial pain for the country, the American people generally would have accepted that, if they understood what had happened and was happening, and that a period of sustained financial stability could have followed. Instead, the controlling politicians opted for a course of action that assures eventual hyperinflation and economic collapse.

Options open to the federal government—for restoring economic growth—involve other matters, particularly regulatory and trade-policy issues, which will be addressed in the *Second Installment*.

No New System Would Succeed Without First Addressing Long-Term U.S. Fiscal Imbalances

Accordingly, it would be the Obama Administration that will have to deal with the hyperinflation, a forced abandonment of the debt standard, and the creation of a new domestic- and global-currency system. Yet, no existing or rejiggered financial system would work for long—including one backed by gold—unless the long-term fiscal circumstances of the United States are addressed and brought into balance. Continued uncontrollable and uncontrollable U.S. fiscal imbalances (see *Chapter 5*) simply would continue to disrupt, and lead to continual devaluation and inflation for, any new U.S. currency.

Purchasing Power of U.S. Dollar Has Collapsed Since 1933

Getting back to the longer-term inflationary impact of the U.S. having abandoned the domestic gold standard in 1933, the effect of the Roosevelt and post-Roosevelt policies has been a slow-motion destruction of the U.S. dollar's purchasing power, as seen in the accompanying *Table I*.

With the U.S. dollar losing 94.4% of its purchasing power (based on the CPI) and 98.6% (based on the ShadowStats-Alternate [1980-Based] measure) since 1933, near-equivalent or greater purchasing-power loss was seen against the precious metals, down by 98.4% versus gold and by 97.8% versus silver.

That means that money invested in the precious metals, since 1933 more than preserved the purchasing power of the dollar against the losses from CPI-U inflation, and effectively preserved the purchasing power against the ShadowStats-Alternate (1980-Based) inflation. (In 1933 it became illegal to own gold privately in the United States, but it became legal again in the early 1970s after Nixon closed the gold window; holding silver was legal throughout the full period.)

The preservation of wealth here in the precious metals is despite the heavy sell-offs seen in gold and silver prices during 2013.

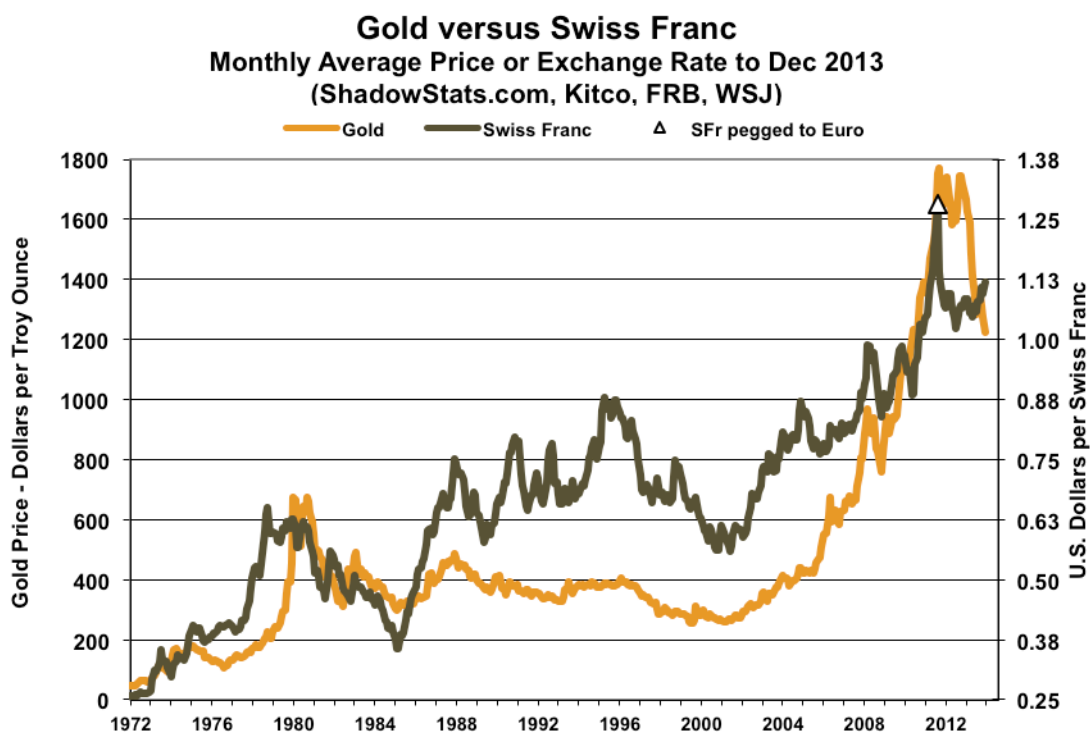
Table I: Loss of U.S. Dollar Purchasing Power

Change in Purchasing Power of the U.S. Dollar Through December 2013 Versus 1914 (Year the Federal Reserve-FRB Became Active), 1933 (Year that Roosevelt Abandoned Domestic Gold Standard), 1970 (Year Leading into Nixon's Closing the Gold Window), and December 2003, the Last Decade				
USD versus	Since January of			In 10 Years Since Dec 2003
	1914 FRB	1933 FDR	1970 Nixon	
Swiss Franc	-82.5%	-82.5%	-78.7%	-29.4%
CPI-U	-95.7%	-94.4%	-83.7%	-20.5%
Silver ¹	-97.7%	-97.8%	-91.7%	-71.3%
Gold	-98.4%	-98.4%	-94.7%	-66.8%
ShadowStats CPI ²	-99.0%	-98.6%	-96.0%	-60.3%
Broad Money Supply ³	-99.9%	-99.7%	-96.0%	-42.8%
Notes: December 2013 data are estimated from available month-end detail. (1) Annual averages used for silver prices in 1914, 1933 and 1970. (2) ShadowStats alternate CPI measure based on 1980 methodologies. (3) Broadest money measure, closest equivalent of M3, including ShadowStats.com ongoing estimate of M3, post-February 2006. Sources: ShadowStats, BLS, FRB, Kitco, St. Louis Fed.				

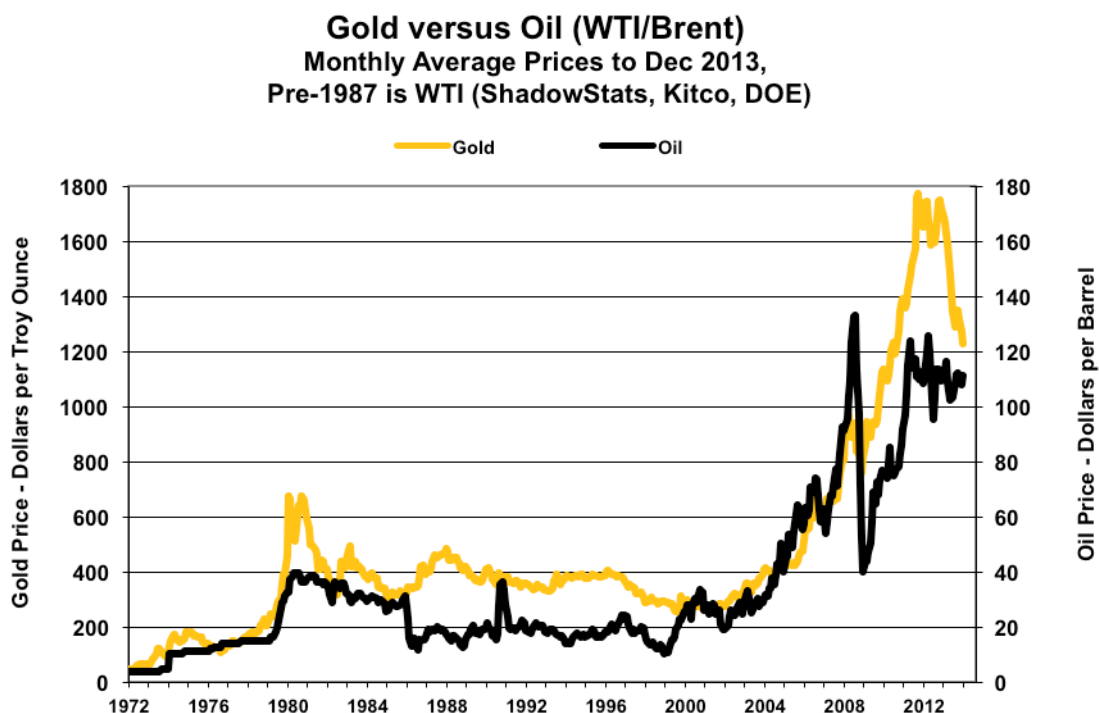
Please note in the above table that gold and the Swiss franc were held constant by the gold standard versus coins in 1914 and 1933. The data are from ShadowStats, the Bureau of Labor Statistics, the Federal Reserve Board, Kitco and the St. Louis Fed. The magnitude of the loss in the U.S. dollar's purchasing in the span of the last century could be repeated in the span of less than 12 months in 2014. Again, fiscal and monetary malfeasance by the federal government and the Federal Reserve are to blame.

The following three graphs reflect the relationships between the price of gold in U.S. dollars per troy ounce, versus dollars per Swiss franc, dollars per barrel of oil and dollars per troy ounce of silver. Each asset can serve as a store-of-wealth, a hedge against the loss of purchasing power in the U.S. Dollar.

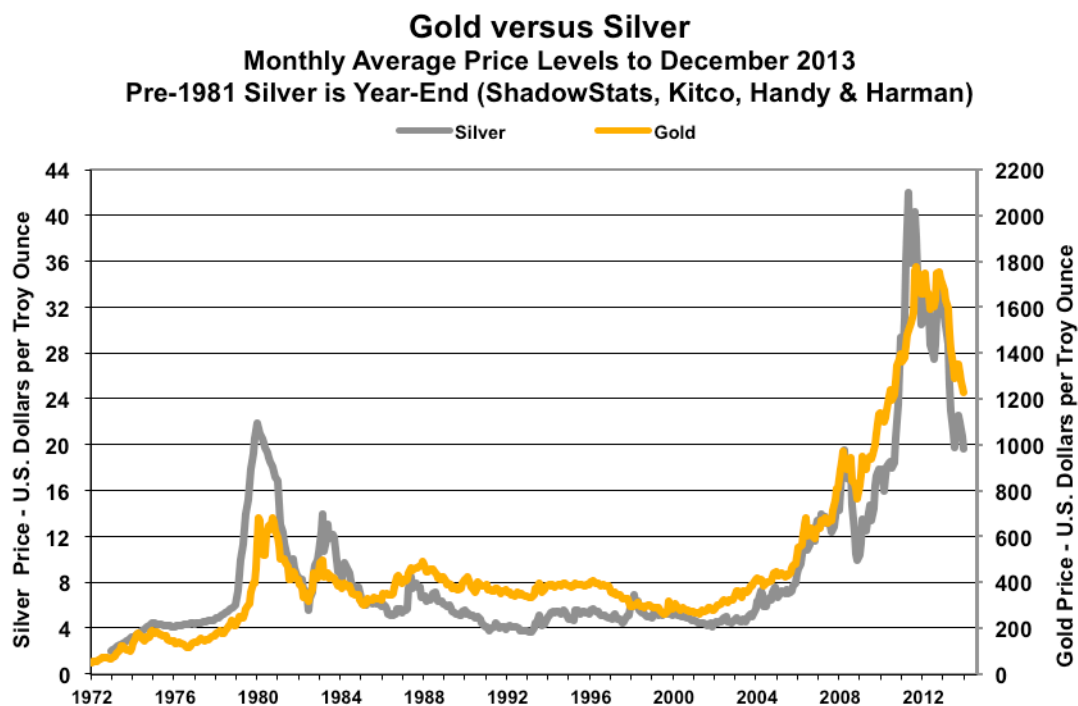
Graph 12: Gold Price and Swiss Franc Value in U.S. Dollars



Graph 13: Gold and Oil Prices in U.S. Dollars



Graph 14: Gold and Silver Prices in U.S. Dollars



Chapter 4—Federal Reserve, Systemic Solvency, and Inflation versus Deflation

Continuing QE3 Props Up the Banking System, Not the Economy

Fed Chairman Bernanke has acknowledged that there is little the U.S. central bank can do, at present, to have meaningful, positive impact on the economy. There also is not much the Fed can do to make the U.S. banking system healthy, although it can provide liquidity to the system, and it will do everything in its power to maintain banking-system solvency. Keeping the banking system sound is the Fed's primary function; supporting sustainable economic growth and containing inflation are secondary considerations.

The quantitative easings, up to and including the latest version of QE3, have been designed to provide the banking system with adequate liquidity, and to provide back-up liquidity to the U.S. Treasury. Yet, those actions have been sold to the public and the media as an effort to boost economic activity. The easing activities even have been assessed as to their effectiveness in the context of, or made contingent upon, economic performance. The Fed simply uses the weak economy as political cover for providing banking-system liquidity, and there is no risk of losing that political cover in the foreseeable future.

As discussed in the section *Sharp Divergence in M3 and Monetary Base*, slowing broad money growth, in an environment of a rapidly expanding monetary base, suggests mounting stresses in the banking system. This is true particularly in the circumstance where the banking system is not lending normally into the regular flow of commerce, where there has been a severe economic contraction, followed by a period of stagnation and no recovery, and now a renewed faltering in broad economic activity.

That circumstance suggests that the Fed's quantitative easing QE3 will be expanded in the near future, not be pulled back meaningfully, as commonly is expected. Ongoing and increasing liquidity needs for the banking system should pressure the renewed expansion of QE3, again with political cover from deteriorating economic activity. The recent initial "tapering" to QE3 was minimal and likely was little more than political window dressing for the benefit of incoming Fed Chairman Yellen.

Due to ongoing solvency issues within the U.S. banking system, the Federal Reserve is locked into a liquidity trap of flooding the system with liquidity, with no resulting surge in the money supply. Yet, the Fed's quantitative easings have, as intended, sporadically damaged the dollar and triggered fleeting inflation from the related roiling of oil prices (see *Chapter 1*). Outside the formal domestic U.S. money supply, the overhang of foreign-held dollars and related liquid assets is in excess of \$16 trillion. As those funds increasingly are dumped into the global markets, the weakening dollar should help to trigger dumping of U.S. Treasury securities, along with general flight from dollar-denominated paper assets. As the Fed moves to stabilize the domestic financial system, the early stages of a currency-driven inflation would be exacerbated by a surge in the domestic money supply, triggered by a surfeit of unwanted dollars. Intensifying the currency-selling crisis are strong odds of a coincident loss of the dollar's global-reserve-currency status.

Preventing Systemic Collapse at All Costs

Collapse of the banking or financial system is not an option for the Federal Reserve or the federal government. Accordingly, they will do everything in their power to prevent, avoid or delay such an event. At best, actions taken to survive the Panic of 2008 have done little more than to delay a day-of-reckoning for the banks and the financial system. Costs of those actions included eventual severe inflation (likely this year), as well as potential constraints, such as a highly vulnerable U.S. dollar, a sell-off in which could have a restraining effect on Federal Reserve and government responses to a system-threatening panic. The system would be extremely lucky to avoid such a panic in the year ahead.

In his ongoing efforts to prevent collapse, Federal Reserve Chairman Ben Bernanke took extreme efforts to liquefy the financial system. The pending collapse of the domestic banking and financial system in September 2008 was real, and it forced the Fed and the U.S. government to act to save the system at any cost. Whatever was needed to back-up or bailout the system in terms of lending, spending, interventions and financial guarantees was provided. Outright takeovers of troubled large institutions ranging, from General Motors, Fannie Mae, Freddie Mac and AIG, to forced mergers, bailouts and takeovers of large financial institutions, were orchestrated by the White House and the Federal Reserve, and were supported by Congress. All these actions were deemed necessary to prevent systemic collapse or to prop the economy, and they were made possible by the Fed's ability to create any amount of money that was needed. The actions of the time brought short-lived stability to the system, but they did nothing fundamentally to remedy the long-range systemic-solvency issues or to foster an economic recovery.

The housing industry had begun to collapse in 2006, which pulled the broad economy into recession and helped to create a crisis with mortgage-backed securities (MBS). The ensuing financial crisis and related panics exacerbated the economic downturn but did not start the recession. None of the actions taken by the Fed and/or the federal government have had significant impact in ending the worst economic downturn since the Great Depression, although the economic collapse would have been more severe if the banking system had been allowed to fail. As will be explored further in the *Second Installment* (also see *Chapter 1*), a severe structural downturn collapsed the broad economy from late-2007 into 2009. The economy did not recover, stagnating and bottom-bouncing instead for the four-to-five years since. Again, a renewed downturn in activity is unfolding, and there is no recovery in sight.

Quantitative Easing Designed to Avoid a 1930s-Style Deflation

By preventing a financial-system collapse at all costs, the Fed is preventing a 1930s-style deflation. As banks failed in the Great Depression of the 1930s, depositors lost their funds, and the money supply collapsed, as did consumer prices. In the Panic of 2008, so long as the bank failures were controlled and those with money in the system were made or kept whole, that type of money supply collapse did not happen. The debt collapse of the recent crisis did not collapse the money supply. Instead, it impaired banks' balance sheets, restricting lending ability. That, in turn, slowed broad money supply growth—even fostered a period of minor contraction in money growth—but it did not create a significant deflationary environment for consumer prices, as had been seen in the 1930s.

Despite the Fed's extreme efforts at liquefying the system in the last five-to-six years, growth in broad liquidity (*i.e.*, money supply M3) generally has been inadequate to support normal economic activity. Where the Fed's "easing" actions have generated temporary, apparent systemic stability, ongoing quantitative easing (QE3) and systemic liquefaction, suggest that the systemic-solvency crisis is far from over.

Nonetheless, efforts by the Federal Reserve in recent years to debase the U.S. dollar met with early “success,” sporadically exacerbating selling pressures on the U.S. dollar, and boosting oil and gasoline prices as part of the plan to increase the pace of consumer inflation. The misguided inflation results never reflected increased economic activity, only rising commodity prices from monetary policies aimed at debasing the dollar. The event of the Fed actually pushing these policies into full force, voluntarily or involuntarily, would be an indication of imminent systemic failure and/or of panic on the part of the U.S. central bank.

In the case of foreseeable events, presumably there is an element of time to prepare for threats to the U.S. banking or financial system. Again, the Fed (and presumably the U.S. Treasury) likely could be counted on to create whatever money, or to take whatever short-term actions were deemed necessary to forestall systemic collapse in the United States. Emergency actions, easing or otherwise, however, also run a high risk of being the proximal trigger for a panicked collapse of the highly-vulnerable U.S. dollar in the global markets, triggering the onset of a domestic hyperinflation.

“Helicopter Ben” on Preventing Deflation

Federal Reserve Chairman Ben Bernanke picked up his various helicopter nicknames and references as the result of a November 21, 2002 speech he gave as a Fed Governor to the National Economists Club entitled *Deflation: Making Sure ‘It’ Doesn’t Happen Here*. The phrase that the now-Fed Chairman Bernanke likely wishes he had not used was a reference to “Milton Friedman’s famous ‘helicopter drop’ of money.”

Attempting to counter concerns of another Great Depression-style deflation, Bernanke outlined what he would introduce as Fed policy six years later as “quantitative easing.” The future Fed Chairman explained in his remarks: “I am confident that the Fed would take whatever means necessary to prevent significant deflation in the United States ...”

As expounded upon by Bernanke, “Indeed, under a fiat (that is, paper) money system, a government (in practice, the central bank in cooperation with other agencies) should always be able to generate increased nominal spending and inflation, even when the short-term nominal interest rate is at zero.”

“Like gold, U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation.”

For the full text of then-Fed Governor Bernanke’s remarks see: [Bernanke 2002 Speech on Preventing Deflation](#).

Sharp Divergence in M3 and Monetary Base Suggests Intensifying Banking-System Stress

Back in September 2008, the Fed started dropping cash from helicopters, as shown in the accompany graphs of the monetary base. The process was repeated with the introduction of QE2 in November 2010, and QE3 in September 2012 with a further expansion in January 2013. A minor, cosmetic pullback in QE3 securities purchases was recently announced for January 2014 (see [Commentary No.](#)

[585](#)). That so-called “tapering” appears to have been more window dressing for the incoming Fed Chairman, than anything else.

As shown in the two graphs of level and year-to-year change (*Graphs 15 and 16*), Bernanke’s spiking of the monetary base has continued to be extraordinary and without historical precedent. The Fed’s renewed panic with QE2 provided a second spike in the monetary base, as did the intensifying panic with QE3 and its expansion. Again, though, despite the active fleet of choppers, systemic liquidity and solvency remain in deep trouble.

Traditionally, the monetary base has been the Federal Reserve’s primary tool for impacting money supply growth. As has been the case for the bulk of the extraordinary expansion of the monetary base, since late-August 2008 through year-end 2013, however, the increase of 329% in the monetary base growth has not been reflected meaningfully in money supply growth.

Annual Growth in Monetary Base Rising at Fastest Pace Since Fed First Addressed 2008 Panic.

Mirroring ongoing QE3 activity, the monetary base has continued into uncharted territory, both in terms of historical level, and in terms of year-to-year growth for the near-term cycle.

As of the two-weeks ended December 25, 2013, the St. Louis Fed’s adjusted monetary base stood at \$3.670 trillion, down from the record-high \$3.716 trillion in the prior period, due to seasonal patterns. Year-to-year growth, however, hit a near-term cycle high of 39.4%, versus 39.3% the prior period, at the highest level seen in a pattern of rising growth, since the Fed first addressed the panic in 2008.

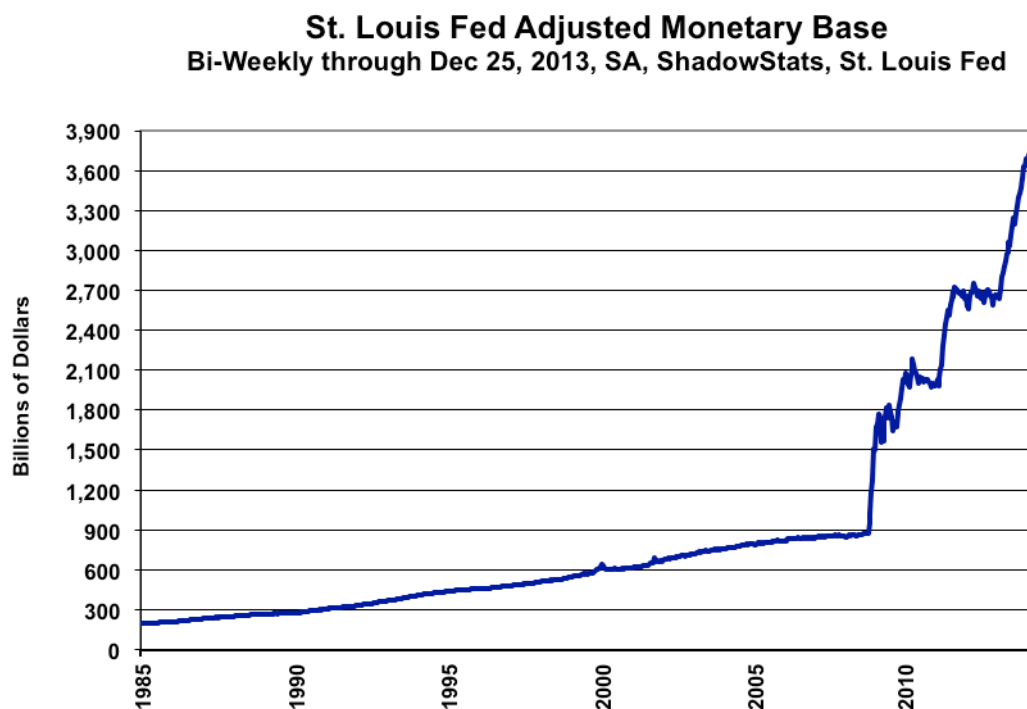
Fundamentally, banks are placing high levels of excess reserves with the Fed, instead of lending the funds into the normal flow of commerce. As a result, bank lending is tepid, and small businesses and consumers are experiencing a horrific liquidity squeeze. This pattern continues despite the Fed’s QE3 buying of Treasury securities.

Annual Growth in December 2013 M3 Money Supply at 15-Month Low. Where the Fed abandoned reporting its broadest money supply measure, M3, in March 2006, the ShadowStats-Ongoing-M3 Estimate for December 2013 year-to-year growth slowed to 3.3%, down from 4.1% in November and down from the near-term cycle peak of 4.7% in January 2013, when the Fed expanded QE3 to include new monthly purchases of U.S. Treasury debt. The December 2013 reading was the weakest since September 2012, as shown in *Graph 17*.

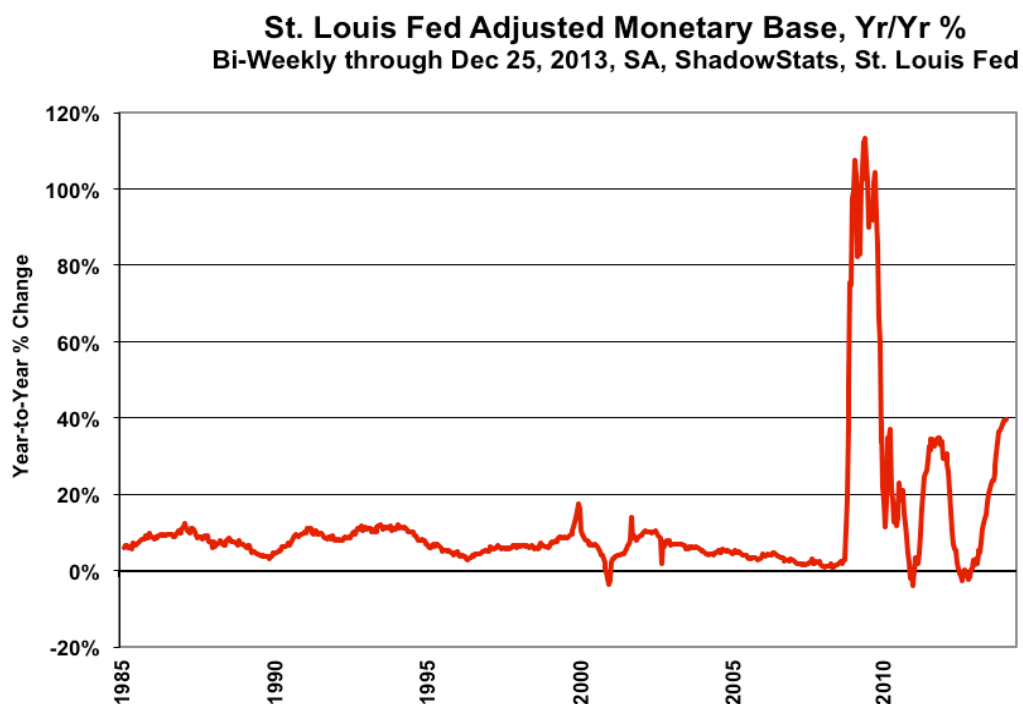
Monetary Base versus M3—Further Near-Term “Tapering” in QE3 Unlikely. The monetary base is currency in circulation (part of M1 money supply) plus bank reserves (not part of the money supply). (See a more-complete definition in the [Money Supply Special Report](#)). Traditionally, the Federal Reserve has used the monetary base to increase or decrease growth in the money supply, but that has not had its normal impact in the post-2008 crisis period.

Instead, financially-troubled banks have been holding their excess reserves with the Federal Reserve, not lending the available cash into the normal flow of commerce. When the Fed monetizes U.S. Treasury securities, as it has been doing, that usually adds directly to the broad money supply, and it contributes to selling pressure against the U.S. dollar. Unresponsive year-to-year growth in broad money supply M3, in this circumstance, tends to be an indication of mounting systemic stress in the banking industry.

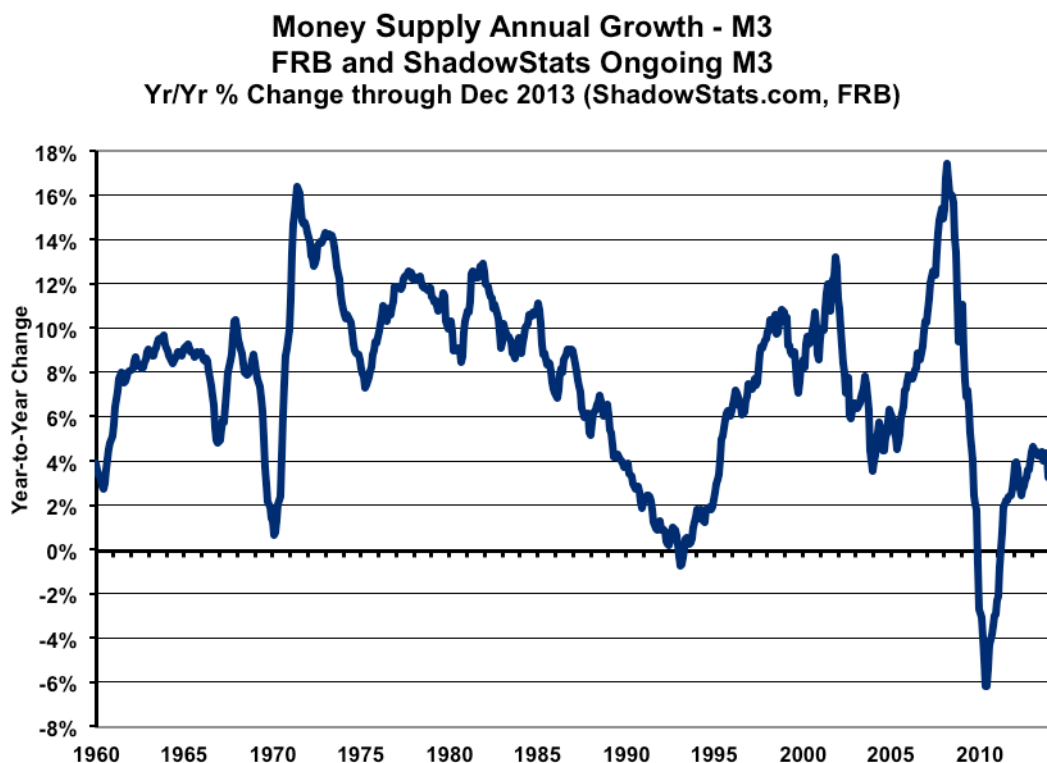
Graph 15: Monetary Base, Level



Graph 16: Monetary Base, Year-to-Year Change



Graph 17: M3, Monthly Year-to-Year Change



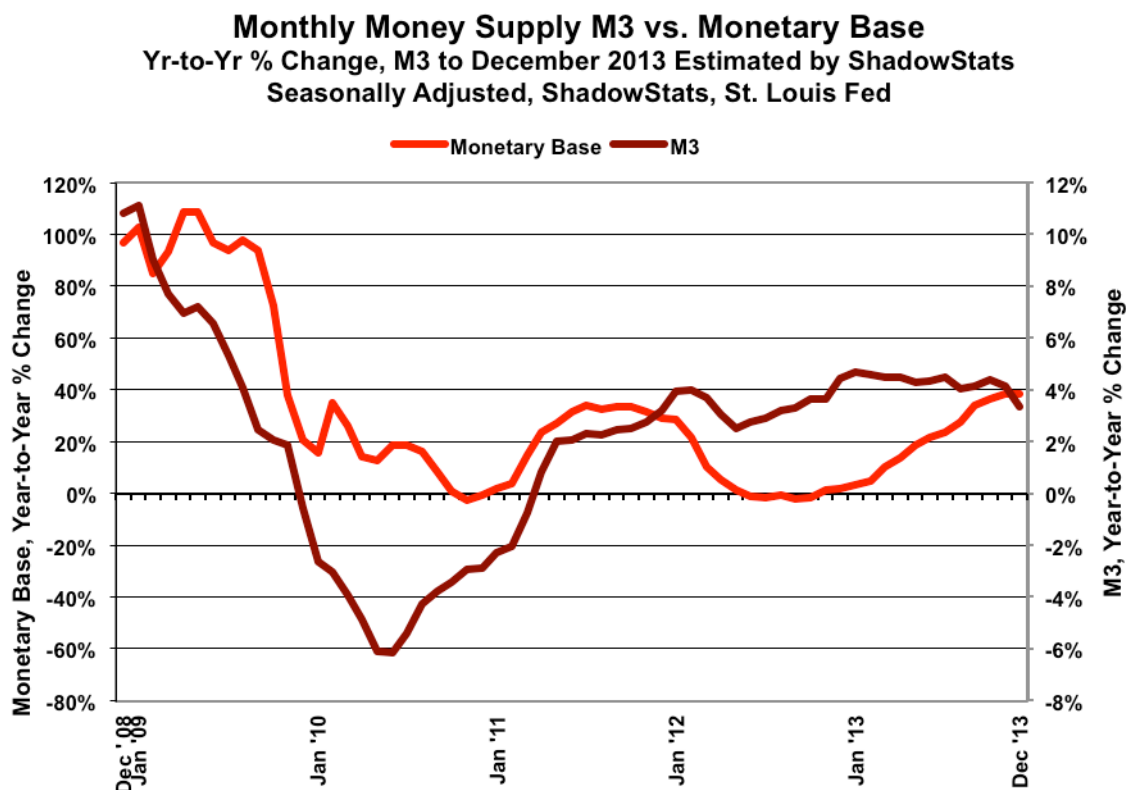
While there has been no significant flow-through to the broad money supply from the expanded monetary base—a problem directly related to banking-system solvency—there still appears to have been some impact. As shown in *Graph 18*, there is a correlation between annual growth in the St. Louis Fed’s monetary base estimate and annual growth in M3, as measured by the ShadowStats-Ongoing M3 Estimate. The correlations between the growth rates are 58.1% for M3, 39.9% for M2 and 36.7% for M1, all on a coincident basis versus growth in the monetary base.

The Fed’s easing activity of recent years has been aimed primarily at supporting banking-system solvency and liquidity, not at propping the economy. When the Fed boosts its easing, but money growth slows or does not respond, there is a suggestion of mounting financial stress within the banking system. If the banks were healthy, they would tend to lend the money and expand the money supply.

The divergence between the patterns of annual growth in M3 and the monetary base intensified in December 2013, suggesting still-intensifying liquidity stresses in the banking system. This is consistent with a recent slowing in already tepid credit growth, and with a renewed downturn in an otherwise moribund economy.

Indeed, underlying U.S. economic reality is weak enough to challenge domestic banking stress tests. In this environment, the Fed most likely will have to continue to provide banking-system liquidity, while still taking political cover for its quantitative easing from the weakening economy. Accordingly, there remains nothing here to suggest a meaningful end to QE3, despite the recent token tapering and mixed jawboning to the contrary by Federal Reserve officials.

Graph 18: Diverging Annual Growth in Monetary Base versus M3



Federal Reserve Monetized 72% of 2013 Net Issuance of Treasury Debt Held by Public

Since the implementation in January 2013 of the Federal Reserve's expanded quantitative easing QE3, the Fed has continued to buy U.S. Treasury securities at a pace suggestive of concerns that the U.S. government otherwise might have some trouble in selling its debt (foreign holdings of U.S. Treasury debt hit a near-term peak in March 2013).

The Federal Reserve is the single largest holder of Treasury securities, with a portfolio 70% larger than that of China. For the 2013 calendar year, the Federal Reserve increased its net holdings of U.S. Treasury debt by \$542.7 billion, or 71.8% of net Treasury issuance of publicly-held debt, 61.3% of the net issuance of gross federal debt during 2013.

During the seven months in 2013, when the U.S. Treasury was functioning just with accounting gimmicks to generate usable funds, with the Treasury debt held at its ceiling, the Fed's effective monetization jumped to over 130% (buying its issues in the open markets from current and earlier years). That ratio pulled back, once President Obama waived the debt ceiling in October. Treasury borrowings surged anew then, as well as with a surge of Treasury borrowing at year-end 2013.

Banks Not Increasing Lending into the Regular Flow of Commerce

An ongoing impediment to post-2008 economic growth has been the paucity in the flow of new credit from the banking system. The Federal Reserve Board's latest flow-of-funds analysis (third-quarter 2013), shows an average 8.4% year-to-year growth in credit-market assets held by U.S.-chartered depository institutions in the five years to 2007 (2007 was 6.7%). Annual growth slowed to 3.7% in the year of the 2008 panic, fell by 3.3% in 2009, rose by 2.3% in 2010, 1.4% in 2011, 3.7% in 2012, and has had three successive quarters of slowing growth in 2013, of 3.5%, 3.0% and 2.7%, respectively. In contrast to the third-quarter 2013 year-to-year growth of 2.7% in credit market assets, reserves on deposit with the Fed for these institutions rose by 69.3% in the same period.

The Inflation vs. Deflation Debate

A number of subscribers have asked that this missive address an ongoing debate in some financial circles as to whether the United States faces inflation or deflation in the near future. With a formal ShadowStats forecast of hyperinflation starting in the year ahead, not too surprisingly, I favor the inflation side of the debate. What is discussed here is the outlook for direction of movement the prices of consumer goods and services, not for financial assets. If the contention is that financial assets, such as equities or bonds, will drop in value, I have no disagreement.

Deflation. The deflation argument appears to run along the lines that debt and credit defaults have been so massive as to offset more than any potential gains in the money supply from Federal Reserve accommodation. Hence, there would be no pick-up in inflation, and the declining money supply would fuel a decline in prices. Formal but minor deflation has taken place several times since World War II, including 2009. Yet, a 1930s-style great deflation, where economic activity and consumer prices both dropped about one-third, would require a collapse in the money supply, and that is not in the works.

While the credit defaults have been massive and have slowed money growth, and where they have had negative impact on economic activity, they did not and will not implode the money supply. Accordingly, the credit defaults, by themselves, lack the ability to trigger a serious deflation.

Consider a bank that lends \$10 million to a customer, who in turn deposits the funds in a bank. A large portion of those funds normally would be loaned to others, by the bank holding the deposit, and so on. In a traditional multiplier effect, the \$10 million loan would create \$100 million in new money supply. If the original borrower then defaulted on the credit or loan and was unable to repay it, and the lending bank could not recover it otherwise, then the loan would become a loss for the bank holding the debt. Separately, the lending bank would not have any ability to pull out of the financial system the \$100 million in money supply that had been created by the initial loan. Accordingly, there would be no direct impact on the money supply from the credit default.

What happens instead of there being a quick hit to the money supply, is that the bank takes a loss, with negative impact to its balance sheet. With an impaired balance sheet, the bank cannot support as much lending as before, with the effect of reduced lending and resulting slower growth in the money supply.

As shown in *Graph 17*, annual broad money growth (M3) did slow following the 2008 panic and turned down into 2010, with the year-to-year decline bottoming at about 6% in mid-2010. Money growth rebounded after that, into 2011, with no obvious impact on consumer inflation in either direction (see the next section on *Inflation and Money Growth*). As shown in *Chapter 1, Graph 5*, year-to-year CPI inflation turned negative in 2009, before the M3 downturn, tied largely to the short-term volatility in oil

and gasoline prices. The minor deflation seen then was no worse than two other minor bouts of deflation of the post-World War II era, in 1949 and 1955. Viewed in terms of the ShadowStats-Alternate inflation measures (see *Definitions*, page 7), the brief deflation of 2009 never took place.

Inflation. As discussed in *Chapter 5*, the current U.S. fiscal circumstance is beyond control, with U.S. financial obligations (debt plus the net-present-value of unfunded liabilities) in excess of \$90 trillion. Where those obligations are beyond the ability of the U.S. ever to cover them with normal financial operations, the most likely outcome over time would be for the U.S. just to print the needed money, which eventually would lead to a hyperinflation and full debasement of the dollar.

Despite the extraordinary liquidity pumped into the system by the Federal Reserve, as discussed previously, the broad money supply has not responded. Part of the reason for that is that troubled domestic banks still are not lending in a normal pattern into the regular flow of U.S. commerce. Part of the reason for this is due to the significant overhang of cash and near-cash assets outside the United States, and outside of U.S. money supply accounting.

As discussed in greater detail in *Chapter 1*, the U.S. dollar faces significant selling pressure in the near future, likely in conjunction with heavy dumping of dollar-denominated assets. As that happens, significant inflation will be triggered by the dollar's decline along with likely meaningful money supply repatriation, as discussed in the next section.

Inflation and Money Growth

In theory, slowing or outright contraction in broad money supply growth should be reflected in slower inflation or outright deflation. As with most economic theories, however, there often are simplifying assumptions that may not be appropriate under certain circumstances, and there often are unusual circumstances. Money supply, for example, works best as a predictor of inflation in a closed system, as was seen with Zimbabwe (see *Chapter 2*).

Money Supply outside the United States. Unlike Zimbabwe, the United States has a significant amount of dollars (currency and near-cash) held outside the country, where shifting dynamics may have significant impact on U.S. inflation. To the extent that aggregate foreign holdings of U.S. dollars are static, with demand and supply in balance, then the circumstances of the simplified money supply model tend to work.

The dollar's global position, though, is not stable or in balance, particularly where the Fed has been working to debase the U.S. currency and to create inflation with its quantitative-easing programs, and where the U.S. government has continued thumbing its nose at the global markets, which have been awaiting some form of action addressing the longer-range U.S. solvency issues.

One data distortion in the money numbers, up front, is in the U.S. currency in circulation, as reported in the narrowest money supply measure, M1. More than half (per the Fed), perhaps more than 70% of the \$1.2 trillion reflected in recent M1 (and monetary base) reporting is physically outside the United States in "dollarized" countries and elsewhere. The reported "currency in circulation" accounts for 44% of M1, 11% of M2 and 7% of M3 (ShadowStats-Ongoing Estimate).

Separately, as reported by the Fed in its third-quarter 2013 flow-of-funds analysis, foreign holders of U.S. assets have something in excess of \$16 trillion in liquid, dollar-denominated paper assets that could be dumped at will into the global and U.S. markets. In perspective, U.S. M3 is about \$15.5 trillion.

As excess dollars are sold or dumped into the global markets, a shift in the tide against the U.S. dollar is reflected in a weakening exchange rate, which in turn spikes dollar-denominated commodity prices, such as oil. Increasingly, that effect has been in response to, or perceptions, of intensifying dollar-debasement efforts by the Fed. Accordingly, brief bouts of U.S. consumer inflation in recent years, and what should be intensified inflation in the year ahead, do not reflect strong economic demand and a surging domestic money supply, but rather come from distended monetary policies and a global glut of dollars.

Demand and supply affect the U.S. dollar's exchange rate. Supply soars and demand shrinks with the increasing unwillingness of major dollar holders to continue holding the existing volume of U.S. currency and dollar-denominated assets, let alone to absorb new exposure.

Therein lies a significant threat to near-term U.S. inflation. Heavy dumping of the U.S. dollar and dollar-denominated assets would be highly inflationary to U.S. consumer prices. It also likely would activate heavy Fed intervention in buying unwanted U.S. Treasuries. When the Fed moves to buy U.S. Treasury securities as the lender of last resort—to monetize U.S. debt still well beyond anything seen to date—that also would tend to trigger renewed growth in the otherwise flagging broad money growth.

The Fed remains the U.S. Treasury's lender of last resort. Panicked dollar selling and dumping of dollar-denominated paper assets—particularly U.S. Treasuries—likely would force the Fed's hand in an increasingly rapid monetizing of Treasury debt. Nonetheless, the Fed's current level of Treasury debt monetization is of enough substance to suggest that the central bank already has recognized a problem there and is addressing it.

Chapter 5—U.S. Government Refuses to Address Its Long-Term Solvency Issues

Annual GAAP-Based Federal Deficit at \$6.8 Trillion, Total Obligations Exceed \$90 Trillion

The fiscal condition of the United States continues to deteriorate each year by an amount that is beyond the control, or the potential of containment, of the federal government. Current annual deterioration is in excess of \$6 trillion. The circumstance remains unsustainable, but those controlling the U.S. government consistently refuse to address the nation's long-term solvency issues.

Fiscal-year 2013 (year-ended September 30, 2013) was no exception, with continued financial deterioration, irrespective of a heavily-gimmicked reporting of a \$680.2 billion cash-based deficit for 2013, having narrowed from \$1,089.4 billion in 2012. Using generally-accepted accounting principles (GAAP), ShadowStats estimates the actual 2013 deficit at \$6.8 trillion, up from \$6.6 trillion in 2012, and total federal obligations at \$92.3 trillion in 2013, versus \$85.4 trillion in 2012. Details are plotted in *Graphs 20, 21 and 22*.

GAAP accounting for the government is similar to that used for large corporations. Corporate accounting usually covers categories such as unfunded liabilities for pensions and retiree health benefits. In the government's financial statements, though, unfunded liabilities for programs such as Social Security and Medicare are included only in the footnotes, but they easily are adjusted into the aggregate financial numbers, as shown in Columns IV to VII of *Table II*.

The table reflects hard data from the 2012 GAAP-based financial statements of the federal government, as detailed in [No. 500: Special Commentary](#). The 2013 GAAP-based statements were scheduled to have been published in mid-December 2013 but have been delayed until February 26, 2014, so the 2013 GAAP-based numbers are ShadowStats estimates.

Cash-Based Deficit. As discussed in [Commentary No. 577](#), a number of special factors were behind the sharp decline in the 2013 headline cash-based deficit to \$680.2 billion from \$1,089.4 billion the year before (Column II). Beyond the expiration of the payroll-tax holiday, there were higher taxes and some reduced spending from sequestration. There also were unusual factors such as dividends from Fannie Mae and Freddie Mac, triggered by accounting gimmicks that were used both to reduce the cash-based 2013 deficit as well as to skirt debt-ceiling problems. Where the gimmicks should be adjusted for in the GAAP accounting, the actual cash-based deficit for 2013 likely was in the one-trillion dollar area.

Gross Federal Debt. Total federal debt, subject to the debt ceiling, basically hit the debt limit of \$16,699,421 million (\$16.7 trillion) in the first week of March 2013, and was held there formally by accounting gimmicks for seven months, through the third week of October. That was after the close of fiscal-year 2013 on September 30th. Formally, the year-end gross federal debt was \$16,738,184 million,

of which, \$16,699,396 million was subject to the ceiling. The debt subject-to-the-ceiling number was held consistently \$25 million shy of the limit for an extended period of time.

Nonetheless those aggregate debt numbers were shy by roughly \$400 billion in obligations that otherwise had been masked by accounting gimmicks and “emergency measures” utilized by Treasury Secretary Jacob Lew, so as to allow the government to operate despite the debt ceiling. There also is another \$100 billion or so that usually gets picked up in the GAAP accounting. The gimmicks were reversed and then funded, once the debt ceiling had been waived by President Obama in October. The 2013 GAAP accounting has to account for the gimmicks, so the gross federal debt in Column VI of *Table II* reflects \$17.2 trillion for 2013, instead of the formal \$16.7 trillion.

Table II: U.S. Government GAAP Accounting, Deficits and Obligations

U.S. Government Annual Fiscal Deficits and Total Obligations GAAP versus Cash Accounting. Sources: ShadowStats.com, U.S. Treasury						
I	II	III	IV	V	VI	VII
Fiscal Year Ended Sep 30	Formal Cash-Based Deficit [Surplus] (\$Billions)	GAAP Ex-SS Etc. Deficit [Surplus] (\$Billions)	GAAP With SS Etc., Raw Deficit [Surplus] (\$Trillions)	GAAP With SS Etc., Consistent-Basis Deficit (\$Trillions)	Gross Federal Debt (\$Trillions)	Total Federal Obligations (GAAP) (\$Trillions)
2013	\$680.2	n.a.	n.a.	\$6.8 ^e	\$17.2 ^e	\$92.3 ^e
2012	1,089.4	\$1,316.3	\$6.6	6.6	16.2	85.4 ¹
2011	1,298.6	1,312.6	4.5	4.5	14.9	80.9 ¹
2010	1,294.1	2,080.3	[7.0] ¹	5.3 ¹	13.6	76.3 ¹
2009 ²	1,417.1	1,253.7	4.3 ²	4.3 ²	11.9	70.5 ²
2008	454.8	1,009.1	5.1	5.1	10.0	65.6
2007	162.8	275.5	1.2	4.2	9.0	59.8
2006	248.2	449.5	4.6	4.6	8.5	58.2
2005	318.5	760.2	3.5	3.5	7.9	53.3
2004	412.3	615.6	11.0 ³	3.4 ³	7.4	49.5
2003	374.8	667.6	3.0	3.0	6.8	39.1
2002	157.8	364.5	1.5	1.5	6.2	35.4
2001 ⁴	[127.0]	514.8	4.5	4.5	5.8	30.3
2000 ⁴	[236.9]	[39.6]	3.9	3.9	5.7	25.9
Last updated: December 31, 2013. (n.a.) Not available. (e) ShadowStats estimates of 2013 GAAP-Based data; release of the Federal Government's GAAP-based financial statement has been postponed until February 26, 2014.						

(e) Estimates of Fiscal-Year 2013 Data:

The detail here will be updated, following the publication of the *2013 Financial Report of the United States Government*, which currently is scheduled for February 26, 2014 (previously scheduled for December 15, 2013). Specific details on the 2013 numbers are discussed in the text.

Columns II & III, Cash-Based and GAAP-Based (Ex-Social Security, etc.) Deficits. The cashed-based deficit for 2013 is as published by the U.S. Treasury, but the sharp narrowing reflects a number of special factors and accounting gimmicks as discussed in the accompanying comments. The GAAP-Based equivalent should be larger, perhaps around \$1 trillion.

Column V, GAAP-Based Deficit. This is a ShadowStats estimate based on available numbers for fiscal 2013.

Column VI, Gross Federal Debt. The formal year-end debt level was \$16.7 trillion, but that was net of roughly \$400 billion in obligations that the U.S. Treasury masked through the use of accounting gimmicks in order to keep the government functioning while the debt level was at its ceiling. When the debt ceiling was waived in October 2013, those gimmicks were reversed and funded (see accompanying text). The GAAP-based accounting should pick-up the differential, and the detail here will be adjusted to the GAAP details, when released.

Column VII, Gross Federal Obligations. The aggregate number here reflects the prior year's estimate, plus the current year's GAAP-based deficit, plus or minus the annual change in intragovernmental federal debt (see note below on *Column VII*).

Sources for the ShadowStats.com Table Data before 2013:

The *2012 Financial Report of the United States Government* (2012 report), the annual GAAP-based financial statements published by the U.S. Treasury on January 17, 2013, are found here: <http://fms.treas.gov/fr/index.html>. Earlier GAAP-based statements are found here: <http://fms.treas.gov/fr/backissues.html>.

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

Formal Cash-Based Deficit (Column II) – The headline cash-based deficit numbers for 2012 and 2011 are from the last section of Table 1, as *Unified Budget Deficit*, on page 3 of the *2012 Report*, “Management’s Discussion and Analysis” (hereinafter referred to as MDA). Earlier years are from the respective financial statements or as otherwise reported by the U.S. Treasury. The 2012 cash-based deficit was \$1,089.4 billion.

GAAP ex-SS Etc., Deficit (Column III) – The simple GAAP-based deficit, before accounting for unfunded liabilities, is referred to as “Net Operating Cost” in the first section of Table 1, on page 3 of MDA in the *2012 Report*. It excludes annual change in social-insurance unfunded liabilities. For 2012, the simple GAAP-based deficit was \$1,316.3 billion,

GAAP with SS Etc., Raw Deficit (Column IV) – The numbers here are calculated as the simple GAAP-number in *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 19) 5th row of data, *Total Social Insurance Expenditures, Net (Closed Group)*, 2012 minus 2011 for the 2012 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 unfunded liabilities for fiscal 2012 and 2011, respectively, were \$51,604 and \$46,272 billion, an annual increase of \$5,332 billion. That, plus the \$1,316.3 billion from *Column III* totals the \$6.6 trillion shown in *Column IV* for 2012.

GAAP with SS Etc., Consistent-Data Deficit (Column V) – The year-to-year changes reflected in the raw-deficit GAAP numbers of *Column III* can be skewed terribly by significant one-time events, accounting and otherwise, and those variations are adjusted for in this *Column V*, so as to reflect the comparative annual deficits on as close to a consistent year-to-year basis as possible. Massive changes were seen in the accounting for the 2004 overhaul of Medicare, which added nearly \$8 trillion to the net present value of 2004 unfunded liabilities, and for the 2010 introduction of the Affordable Care Act (ACA), which purportedly reduced 2010 unfunded liabilities by more than \$12 trillion. The affected years have been 2004, 2007, and 2010. Detail is discussed in the related footnotes.

Gross Federal Debt (Column VI) – The gross federal debt is as indicated in “Note 14. Federal Debt Securities ...” pages 91 to 93 of the *2012 Report*: total held by public (page 91) plus total intragovernmental (page 93). These numbers may differ from other Treasury tallies, as the totals include accrued interest payable. For 2012, gross federal debt totaled \$16,185 billion, composed of \$11,332 billion public, \$4,853 billion intragovernmental.

Total Federal Obligations (Column VII) – From the *2012 Report*, total Federal Obligations include balance-sheet liabilities (\$18,849 billion), from the *Total Liabilities* line in the second section of MDA, Table 1, page 3; plus total intragovernmental

debt of \$4,853 billion on page 93; plus the 2012 *Closed Group* net present value unfunded liabilities of \$51,604 billion (official) plus the alternative differential of \$10,071 billion (see *Column V* and page 135 of the 2012 *Report*); which total \$85.4 trillion.

The *Total Liabilities* account in the consolidated financial statements formally excludes intragovernmental debt, where the non-public debt is debt the government owes to itself for Social Security, etc. Those obligations are counted as “funded,” however, and, as such, are part of total government obligations and are added back in here.

See footnote (1) for a discussion on the inclusion of the GAO’s alternative scenario of unfunded liabilities for the ACA in the total obligations number shown in *Column VII*.

Footnotes:

¹ As reported in *Column VII* of the table, fiscal years 2010 through 2012 reflect alternative-scenario measures on the size of the government’s unfunded liabilities, as put forth by the Government Accountability Office (GAO) in its notes to the financial statements of those years (2013 is estimated on what would be a consistent basis). Also, just for 2010, the GAO alternative is used in *Column V*, which results in an annual \$12.4 trillion swing in the raw 2010 GAAP-based surplus of \$7.0 trillion, shown in *Column IV*, to a \$5.3 trillion deficit (there is a rounding difference). In order to maintain consistency with the official estimates, the raw-deficit data are published in *Column III*.

In fiscal 2010, the Administration estimated a one-time \$12.4 trillion reduction in the 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, ShadowStats estimated that the GAAP aggregate GAAP-based shortfall would have been roughly \$5 trillion, instead of the proffered aggregate \$7 trillion surplus.

The GAO-Alternative numbers were used here to adjust for those issues, reflecting results using the “Illustrative Alternative Scenario” on Medicare costs shown on page 130 of the 2010 *Report*, page 134 of the 2011 *Report* and on page 135 of the 2012 *Report*. The alternative calculations post-2010 were not particularly dynamic, but those numbers are being used as placeholders for the *Total Obligations* numbers, until such time as better accounting estimates are available.

² The 2009 data predate December 2009 guarantees of Fannie Mae and Freddie Mac (GSEs) and do not reflect Pension Benefit Guaranty Corporation or FDIC liabilities. Even so, the accounting for 2009 to 2013 reflect nothing of what might be considered direct, full faith and credit guarantees of the U.S. government in those areas. Please note that mid-year 2009 accounting redefinitions for TARP knocked off roughly \$500 billion from the reported formal cash-based estimate and contributed to a TARP “profit” in the GAAP numbers. Accordingly, post-2008 reporting may understate annual operating shortfalls and federal debt obligations by significant amounts.

³ ShadowStats estimates a \$3.4 trillion consistent-basis total 2004 GAAP-deficit, excluding the one-time and initial unfunded liabilities for the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (enacted December 2003), which pushed the annual GAAP-based deficit to \$11.0 trillion. In order to allow consistency with the official GAAP statements, the raw “official” numbers are shown in *Column IV*; the “consistent” accounting is shown in *Column V* of the table.

⁴ The statements for 2000 and 2001 were not audited. Where the GAO has audited the government’s financial statements from 2002 to 2012, the GAO has found varying “material” issues with the government’s reporting and regularly does not offer an opinion on the statements.

Federal Debt and Unfunded Portion of Future Liabilities at Record High

GAAP-accounting for unfunded liabilities reflects net-present-value (NPV), where the stream of unfunded obligations into the future is discounted for the time-value of money. Effectively, NPV is the amount of interest-bearing funds needed in hand, today, to cover future obligations as they come due.

As of 2013, the total value of federal obligations—including gross federal debt and the NPV of the unfunded portion of liabilities for programs such as Social Security—was a record \$92.3 trillion. With

roughly \$75 trillion of that total in unfunded liabilities, the U.S. would have to set aside \$75 trillion, in hand, today, to maintain the long-term solvency of the country. With nominal (not-adjusted-for-inflation) U.S. GDP at \$16.6 trillion for fiscal-year 2013, and with M3 in September 2013 at \$15.4 trillion, setting aside such an amount is physically impossible, shy of a hyper-inflating Fed. The total \$92.3 trillion of obligations was 5.55 times the 2013 GDP, versus 5.31 the year before (see *Graph 20*).

Those ratios, though, were based on using in the denominator the just-redefined U.S. GDP, which upped overall annual U.S. economic activity by 3.5% from what it would have been otherwise. That means the total obligation-to-GDP ratio in 2013, based on traditional GDP reporting, would have been a record 5.75, with 2012 reporting at 5.49. Use of the original GDP is closer to the reporting of other countries.

In 2013, alone, gross federal debt of \$17.2 trillion (even the gimmicked \$16.7 trillion number) exceeded annual GDP (see *Graph 21*).

Comparative Unfunded Liabilities

A common question with such a number is how does the U.S. ratio compare with other countries. The general answer, as best I can determine it, is that the U.S. has the highest ratio of total obligations (including NPV of unfunded liabilities) to GDP of any country or region tied to any of the seven most-widely trade currencies: U.S. dollar, euro, yen, pound, Swiss franc, Australian dollar and the Canadian dollar. It is difficult, however, to get consistent numbers and definitions for comparison purposes.

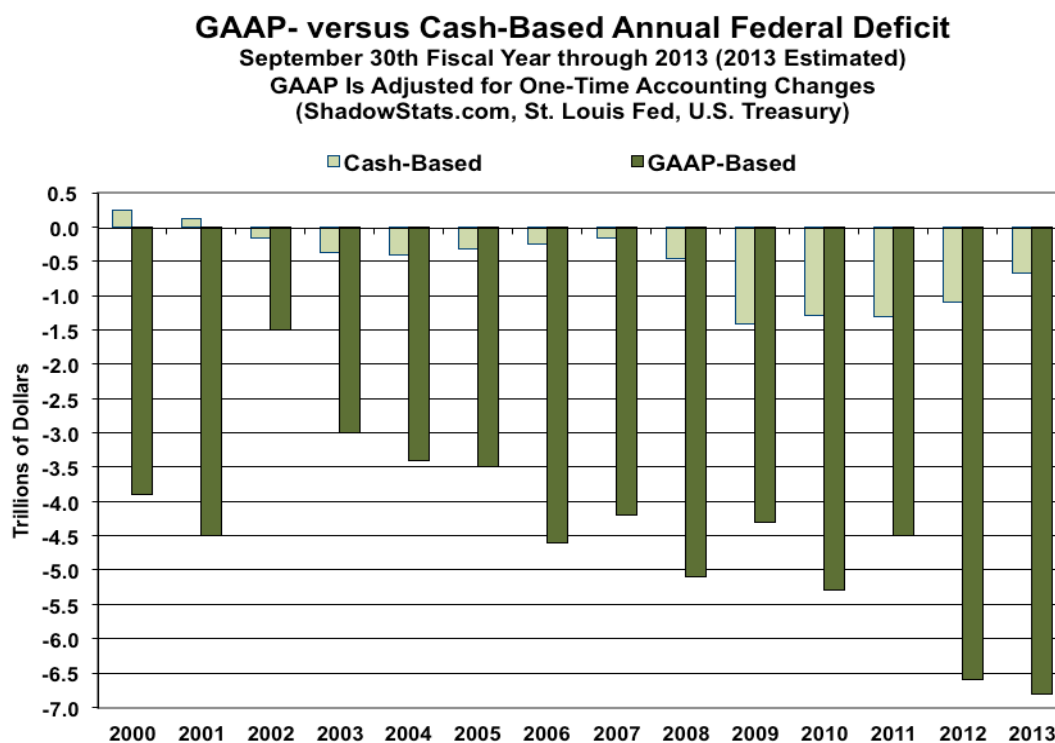
One subscriber offered detail from a January 2009 report of Jagadeesh Gokhale, of the National Center for Policy Analysis: “Measuring the Unfunded Obligations of European Countries.” Gokhale’s work suggested a euro-area ratio of about 4.3, in 2004, versus a U.K. ratio of 4.4. His estimate of the U.S. shortfall in 2004 suggested a ratio of roughly 5.4, in contrast to the European measures, yet ShadowStats showed a 2004 U.S. ratio of 4.24, on a basis consistent with the 5.75 number estimated for 2013, using the old-line GDP. Different analyses may use different assumptions, with different results. My 2004 estimate was based on the GAAP accounting published by the U.S. Treasury and audited by the GAO. Nonetheless, the relative U.S. ratio appears to have been higher than the U.K. or euro ratios in 2004, and intervening developments would suggest those difference might have expanded.

If the U.S. GAAP accounting included obligations tied to Fannie Mae and Freddie Mac, and liabilities for the Pension Benefits Guarantee Corporation (PBGC), the U.S. ratio would have been pushing 6.7 in 2013 (old-line GDP).

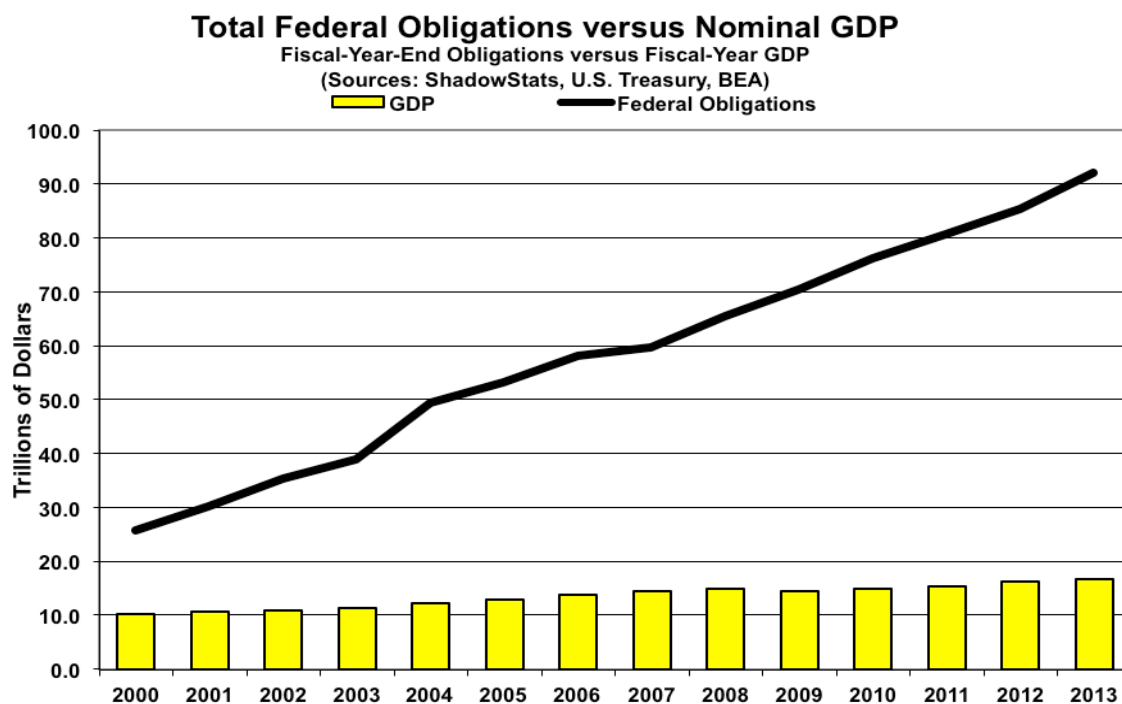
Annual Deficits of Six-Plus Trillion Dollars Are Not Sustainable

Beyond the issue of having to set aside \$75 trillion in cash now (or change the system to put it into operational balance), as discussed previously, those looking at the current \$92 trillion of government debt and obligations, who think such is stable, need to consider that the circumstance is not static. Rather, it is getting worse each year by more than \$6 trillion, in today’s money. Taxes cannot be raised enough to cover one year’s worth of GAAP-based annual shortfall, let alone to stabilize future negative cash flows. Every penny of government spending—except for Social Security and Medicare—could be cut and the system still would be in annual deficit. Massive cuts or reorganization would have to be put in place now (an absolute necessity with the social insurance), if there were to be any hope of restoring long-term solvency for the United States government, but those areas were removed as options the most recent budget-deficit deal.

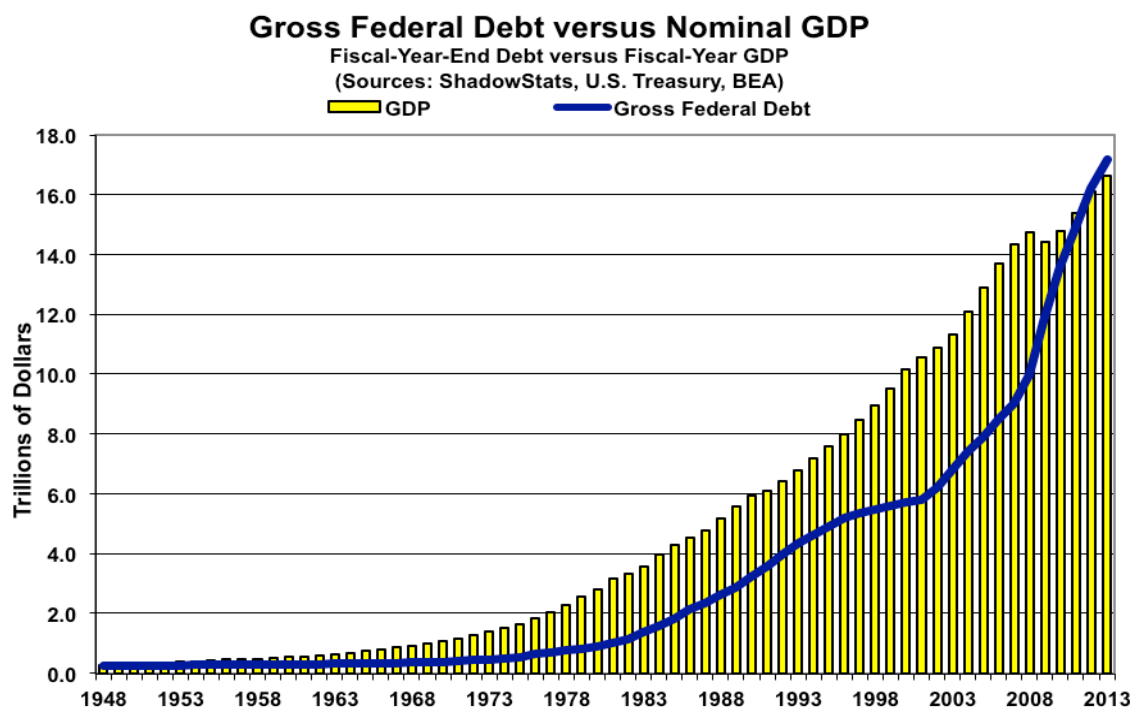
Graph 19: GAAP- versus Cash-Based Annual Federal Deficit



Graph 20: Federal Obligations versus GDP



Graph 21: Gross Federal Debt versus GDP



Fiscal, Monetary and Economic Distortions Threaten the U.S. Dollar and Financial Stability

There is no political will apparent among those currently controlling the White House and Congress to restore long-term U.S. solvency. That has been evident in the debt-limit and federal-budget negotiations of recent years, up to and including the recently signed budget deals for 2014 and 2015. Those deals appear to have been aimed at forestalling having to address the longer-range U.S. solvency issues, until after the 2014 mid-term election.

Without corrective action, the U.S. is doomed to an eventual hyperinflation, following the course taken by most sovereign states that have spent beyond their ability to raise money, and eventually printing the money needed to meet their obligations. As noted earlier, that process already has started, thanks to the Fed's quantitative-easing programs. Due to this circumstance, a faltering economy that never recovered, and the systemic disruptions and panics that evolved around the 2007 and 2008 crises, the U.S. should suffer a dollar-killing currency selling panic before the 2014 election. There likely is no more time to resolve the long-range U.S. solvency issues.

Coming into the 2013 budget negotiations, which were a function of multiple continuations of the budget-deficit crisis talks in 2011, there was little time left to restore global confidence in long-term U.S. solvency. Instead of addressing the concerns of those who had been funding U.S. deficit operations before the Fed stepped in, and of those still holding significant amounts of U.S. Treasury debt, the politicians controlling the Congress and the White House thumbed their noses at global-market

concerns, hoping to push the funding issues into the future, once again. That likely will be viewed as a mistake, once the global markets begin to dump the U.S. dollar.

The U.S. economy is faltering anew, and headline business data should turn down sharply in the months ahead, intensifying broad expectations of a “new” recession. Implications for the budget deficit are horrendous, since current budget-deficit projections are based on strong economic growth going forward, not a recession. These areas will be explored more completely in the upcoming *Second Installment*.

With 2014 an election year, a rapidly slowing economy, or one in downturn, would tend to push the Congress and the White House into fruitless, but budget-busting actions aimed at stimulating growth. Accordingly, a market-sentiment-shifting weak economic statistic, or renewed efforts to expand, not to contain, the federal budget deficit could trigger a dollar sell-off.

In like manner, the next Fed action to help the economy (a.k.a. propping-up banking system liquidity) by not pulling back further on the “quantitative easing” or even by expanding QE3, easily could be the trigger for pushing the U.S. dollar into the abyss.

Even in the event the global markets do not push the dollar into a downward, death spiral before the election, the electorate likely will not be in a mood to re-elect existing members of Congress who have been playing poll-based politics of the moment, while the U.S. economic and financial systems have been dumped over a cliff. Come election time, the economy will be much weaker, consumer income and liquidity issues will be more severe, and suffering voters likely will be ready for some shift in those controlling the Congress.
