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

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Section Four of Four

Reporting/Market Focus

GAAP-Based 2008 Federal Deficit Hits $5.1 Trillion

Government Bankruptcy/Hyperinflation Just a Matter of Time

As discussed in the December 15th *Alert*, the U.S. Treasury published its *2008 Financial Report of the United States Government* on December 15th: http://fms.treas.gov/fr/08frusg/08frusg.pdf. A summary of the generally accepted account principles (GAAP)-based detail is shown in the table on the following page. Against what had been the recently publicized, cash-based "official" fiscal 2008 (year-ended September 30th) federal deficit of $454.8 billion, and parallel $161.8 billion deficit in 2007, the U.S. Treasury reported that the 2008 deficit [change in net position] was $1,009.1 billion, versus $275.5 billion in 2007, using GAAP. Since 2002, the Treasury has been reporting the government's finances using annual statements prepared using accounting standards similar to those used in corporate America.

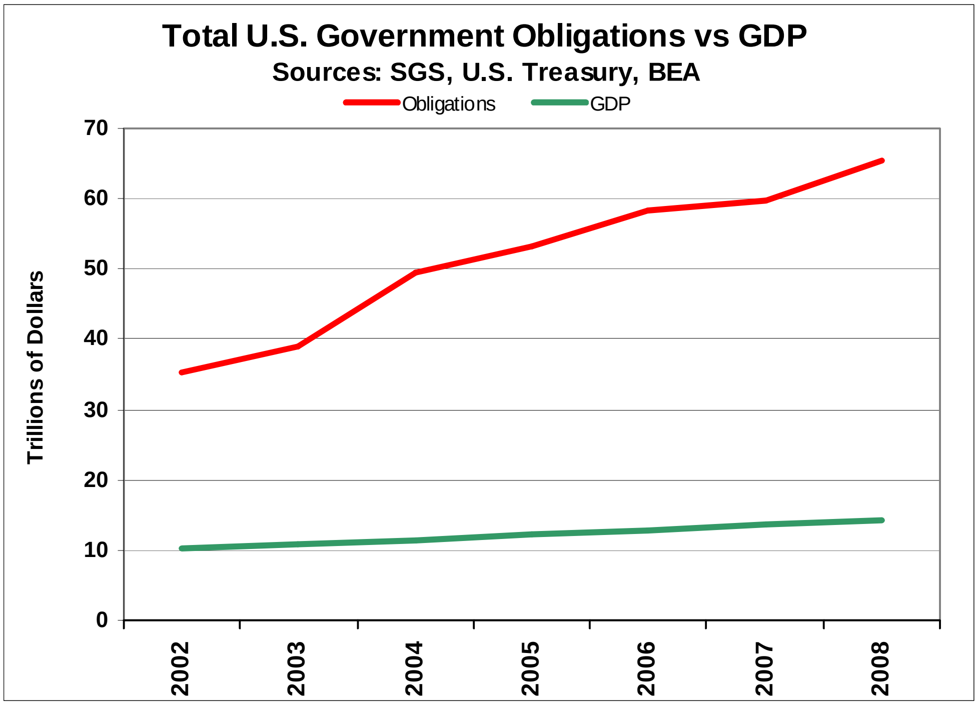
Those numbers, however, did not account for the annual change in the net present value of unfunded Social Security and Medicare liabilities, except in discussions and footnotes. Counting those changes, as a corporation would for its pension and healthcare liabilities for retirees, the 2008 annual deficit was $5.1 trillion, versus $1.2 trillion in 2007. Such showed total U.S. obligations -- gross federal debt outstanding plus the net present value of unfunded liabilities -- at $66 trillion, roughly 4.6 times the level of reported U.S. GDP, and greater than total estimated global GDP. These numbers are unsustainable, as suggested in the accompanying graphs, and already are deteriorating severely for fiscal 2009. They also doom the U.S. dollar to hyperinflation, as discussed in the *Hyperinflation Special Report* of April 8, 2008.

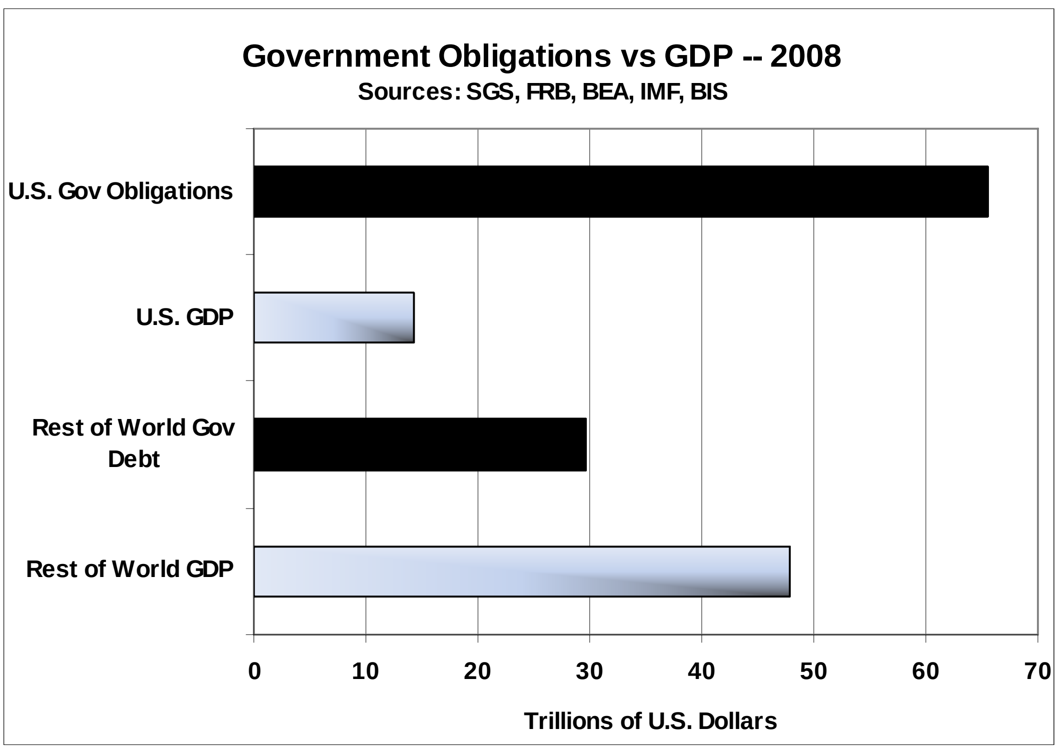
U.S. Government - Alternate Fiscal Deficit and Debt
Reported by U.S. Treasury

Dollars are in either billions or trillions, as indicated.
Sources: U.S. Treasury, Shadow Government Statistics.

Fiscal Year [1]	Formal Cash-Based Deficit ($Bil)	GAAP Ex-SS Etc. Deficit ($Bil)	GAAP With SS Etc. Deficit ($Tril)	GAAP Federal Negative Net Worth ($Tril)	Gross Federal Debt ($Tril)	Total[2] Federal Obligations (GAAP) ($Tril)
2008	$454.8	$1,009.1	$5.1	$59.3	$10.0	$65.5
2007	162.8	275.5	1.2[3]	54.3	9.0	59.8
2006	248.2	449.5	4.6	53.1	8.5	58.2
2005	318.5	760.2	3.5	48.5	7.9	53.3
2004	412.3	615.6	11.0[4]	45.0	7.4	49.5
2003	374.8	667.6	3.0	34.0	6.8	39.1
2002	157.8	364.5	1.5	31.0	6.2	35.4

(1) Fiscal year ended September 30th. (2) Includes gross federal debt, not just "public" debt. While the non-public debt is debt the government owes to itself for Social Security, etc., the obligations there are counted as "funded" and as such are part of total government obligations. (3) On a consistent reporting basis, net of one-time changes in actuarial assumptions and accounting, SGS still estimates that the GAAP-based deficit for 2007 topped $4 trillion, with negative net worth of $57.1 trillion and total obligations of $59.8. So as to maintain consistency with the official GAAP statements, the "official" numbers are shown in the table for 2007. (4) SGS estimates $3.4 trillion, excluding one-time unfunded setup costs of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (enacted December 2003). Again, in order to maintain consistency with the official GAAP statements, the "official" numbers are shown in the table for 2004. Link to the 2008 statements: http://www.fms.treas.gov/fr/08frusg/08frusg.pdf


Total U.S. Government Obligations vs GDP
Sources: SGS, U.S. Treasury, BEA
Obligations
GDP
Trillions of Dollars
0
10
20
30
40
50
60
70
2002
2003
2004
2005
2006
2007
2008


Government Obligations vs GDP -- 2008
Sources: SGS, FRB, BEA, IMF, BIS
U.S. Gov Obligations
U.S. GDP
Rest of World Gov Debt
Rest of World GDP
0
10
20
30
40
50
60
70
Trillions of U.S. Dollars

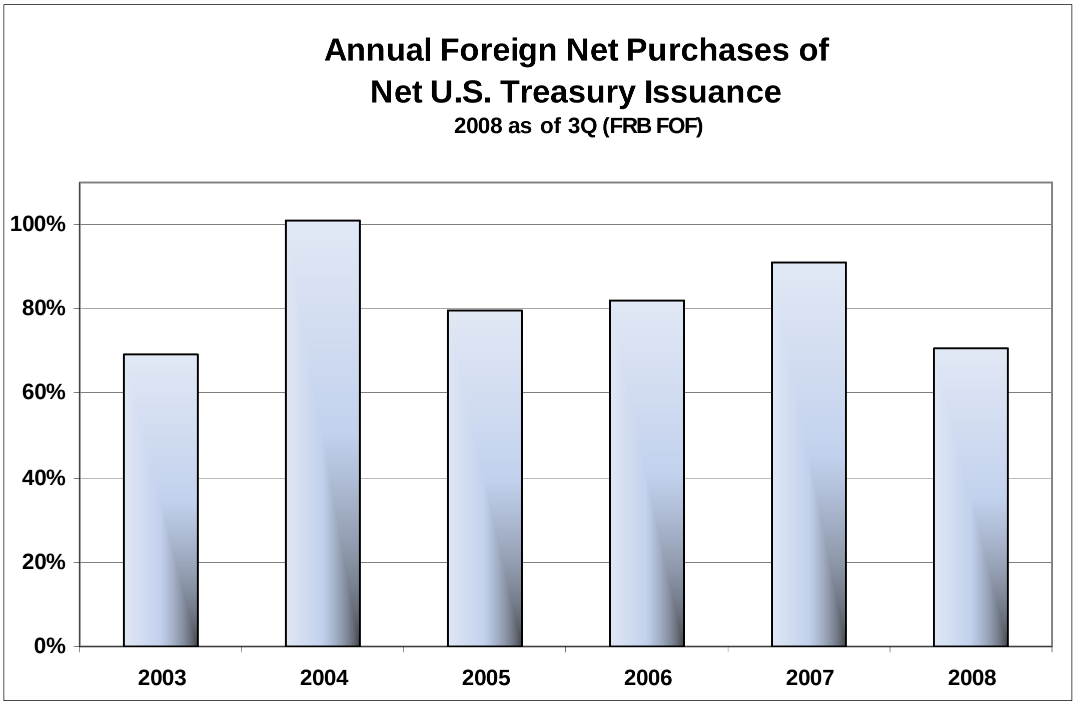
An actual U.S. deficit of $5.1 trillion is uncontainable, and it is about to get a great deal worse. The shortfall cannot be covered by taxes, and the needed spending cuts tied to Social Security and Medicare cannot be worked politically. The rapidly deteriorating economic conditions promise reduced tax revenues, while the incoming Obama Administration has promised significantly increased spending.

Impact of Systemic Solvency Crisis to Be Seen in 2009 Numbers. As the U.S. Treasury responded in tandem with the Federal Reserve in 2008 to address a collapsing financial system, placing Freddie Mac and Fannie Mae into conservatorship added about $13 billion to the annual deficit and government liabilities for fiscal 2008. Most of the impact from that and other actions, however, will not show up until 2009 accounting. In like manner, the Troubled Asset Relief Program (TARP) was not enacted until fiscal 2009 and will be so accounted for.

As reported so far in fiscal 2009 (see the Federal Deficit comments in the Reporting section), the "official" cash-based (not GAAP-based) accounting shows for October and November 2008 -- the first two months of the 2009 fiscal year -- that the official deficit more than doubled to $401.6 billion, from $154.1 billion in the same period of fiscal 2008.

Faced with collapsing economic activity, President-elect Obama has promised a massive economic stimulus package that likely will total close to $1 trillion, spiking the "official" cash-based deficit to possibly $2 trillion in fiscal 2009, more than four times the 2008 record level. All that will have to be funded by the U.S. Treasury, on top of its regular refunding needs. Therein lies a problem for the markets and the incoming Administration.

U.S. Treasury funding needs exploded by about $500 billion in October 2008. Yet, even as Treasury issuance began to spike in calendar third-quarter 2008, foreign purchases of those instruments began to falter, as reflected in the Federal Reserve's flow-of-funds data, which tend to be unreliable. Nonetheless, the U.S. Treasury has relied on foreign net purchases of an average 80% of its net debt issuance since 2002. As foreign investors increasingly shy away from a losing proposition with the U.S. dollar, faltering demand for U.S. Treasuries will become a problem for the Federal Reserve, the U.S. Treasury buyer of last resort. At such time as the Fed monetization of U.S. debt accelerates meaningfully, the risks of hyperinflation will move in over the horizon.



Risks of U.S. Default. As discussed in the prior newsletter, stories keep circulating in the global markets of a possible default on U.S. debt within the next year or so, as result of the explosive growth in federal debt. Such remains unlikely, unless foreign lenders start making not-so-unreasonable demands that the United States issue its debt in yen, pounds, euros, etc. As shown by the latest GAAP-statements, the United States already had no prospects of ever honoring the obligations that were in place before the current crisis, which will push this year's cash-based deficit possibly to $2 trillion (perhaps $8 trillion GAAP). Under such circumstances, most governments would opt to use the printing press to inflate their way out of debt, rather than to go through a formal debt default.

That is why the agencies that issue sovereign debt ratings usually will give a "AAA" rating, when debt is issued in the sovereign's currency, backed by the power of being able to create whatever currency is needed in order to meet the obligations.

If, however, the U.S. had to start covering new obligations in something other than the U.S. dollar, then the risk of formal default would become meaningful, and sovereign ratings on non-dollar U.S. Treasury debt easily could fall below investment grade. Given that the U.S. government has no way out of its obligation bind within the traditional system, offering non-U.S. dollar denominated debt would not be a desirable option. Such would raise the risk of actual debt default and a possibly ratings downgrade that would not otherwise be seen, while possibly accelerating the onset of hyperinflation in the process.

