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

Number 48

January 3, 2009

Section One of Four

OVERVIEW

Multiple-Dip Depression Unfolds

Solvency Crisis to Engulf U.S. Government Finances

Stimulus Efforts Would Enhance Hyperinflation Risk

Broad Money Growth Spikes

OVERVIEW -- OPENING COMMENTS

Obama Administration to Push Practical Limits of Effective U.S. Fiscal Bankruptcy

By April, the rapidly deteriorating recession will be viewed commonly as the worst downturn since the Great Depression. Fearing same, the incoming Obama Administration is promising stimulus in the form of massive federal spending. Concerns about the government's fiscal condition can wait until the economy recovers, we are being told. A similar pacifying assurance presumably extends to inflation concerns as well.

Unfortunately, with the economy in a structural downturn (as discussed in the last newsletter) and with the U.S. government effectively bankrupt (as discussed in the Reporting/Market Focus section), there can be no rapid or normal recovery. As inflationary pressures mount anew and the financial markets increasingly shun U.S. Treasuries, an inflationary depression can evolve quickly into a hyperinflationary great depression. Although hyperinflation became inevitable in the last decade, the onset of the process just recently was triggered by Fed and the Treasury actions in addressing the systemic solvency crisis. The process would be accelerated by unfettered and unfunded government spending that appears to loom in early 2009.

The recession is official now, but, as usual, its depth and length have been underestimated. Ahead lies continued economic downturn that likely will evolve as a multiple-dip depression and ultimately a great depression, as hyperinflation eventually kicks in and collapses normal commercial activity. The historical context of the current structural downturn in economic activity

was discussed in some detail in the *SGS Newsletter No. 47* of November 14, 2008, and is included here by reference.

On the plus side, the tumultuous financial markets appear to have calmed a little, and the Federal Reserve's panicked liquefaction of the U.S. financial system appears to have triggered some positive early response in bank lending. Yet, along with any relative market tranquility, growth in the broad money supply is spiking anew, and the U.S. dollar has come under renewed selling pressure. The monetary and currency developments bode poorly for the inflation outlook -- despite the recent collapse in oil prices and a possible negative reading for December annual CPI -- and intensified dollar selling even could start to boost dollar-based oil prices, again. In the year ahead, dollar weakness, an inflation threat (not broadly perceived, yet) and rapidly expanding global political tensions, all will be fodder for the gold market.

Over the long-term, the broad outlook is little changed. As to the equity and credit markets, difficult times lie ahead, with impaired corporate revenues and profits in the deteriorating economic circumstance, and with long-term interest rates likely to move much higher. Rates should rise as financial-panic pressures subside and funds flow out of U.S. Treasuries in response to ongoing dollar debasement (inflation). Again, over the long-term, the U.S. dollar should suffer significant selling, with both gold and silver rallying sharply, partially in response to the greenback's problems.

Formal Deflation in December CPI? Watch Out for 2009! With collapsing oil prices having pushed the reported annual CPI-U down to 1.0% in November, continued pressures may push the annual CPI-U inflation rate negative in December (see the CPI comments in the Reporting section). While such likely would be extremely shallow and short-lived, it would be formal deflation, nonetheless, the first since the 1950s. Of course, CPI reporting methodologies have changed meaningfully in the last 60 years, and as indicated by the SGS-Alternate CPI measures, today's zero inflation would be around three-percent or eight-percent, using the respective CPI methodologies in place as of 1990 or 1980.

With oil and gasoline prices having continued to sink into December, with the dollar having strengthened into December, with M3 growth and money velocity likely having slowed into November, and with the prices-paid component of the December purchasing managers manufacturing survey at a 60-year low, it could be hard to argue that much higher inflation looms in 2009.

That said, oil and gasoline prices appeared to be close to a bottom at year-end 2008, with selling pressures mounting anew on the U.S. dollar. A slowing global economy has softened demand for oil, but OPEC has been and likely will continue to address that with production cuts. Also, with the U.S. election out of the way, political tensions in the Middle East and elsewhere around the globe are on the rise again.

Key to the pricing of dollar-denominated commodities -- particularly oil -- is the value of the U.S. dollar against other currencies. The greenback was manipulated higher, after the Bear Stearns crisis in March, and then suffered extreme distortions as the global financial meltdown forced liquidations of various financial instruments among troubled firms. Dollar fundamentals remained extremely negative, however, and, in the second half of December, net selling pressure resumed on the U.S. currency. Such likely will intensify in the months ahead. If so, not only should oil prices bottom, but they also likely will begin to turn sharply to the upside, once again (see the U.S. Dollar and Oil comments in the respective Markets and Reporting sections).

Most significantly, however, annual M3 growth resumed its upswing in December, beginning to absorb the extreme liquidity pumped into the system by the Federal Reserve. With annual M3 growth rising to an estimated 10.4% in December, from 8.9% in November, growth topping the

17.4% historic high seen in March 2008 likely will be seen before March 2009. Such levels exceed the 16.4% previous historic high of June 1971, which was two months before President Nixon closed the gold window and instituted wage and price controls. Shy of hyperinflation, consumer inflation should hit double digits in 2009.

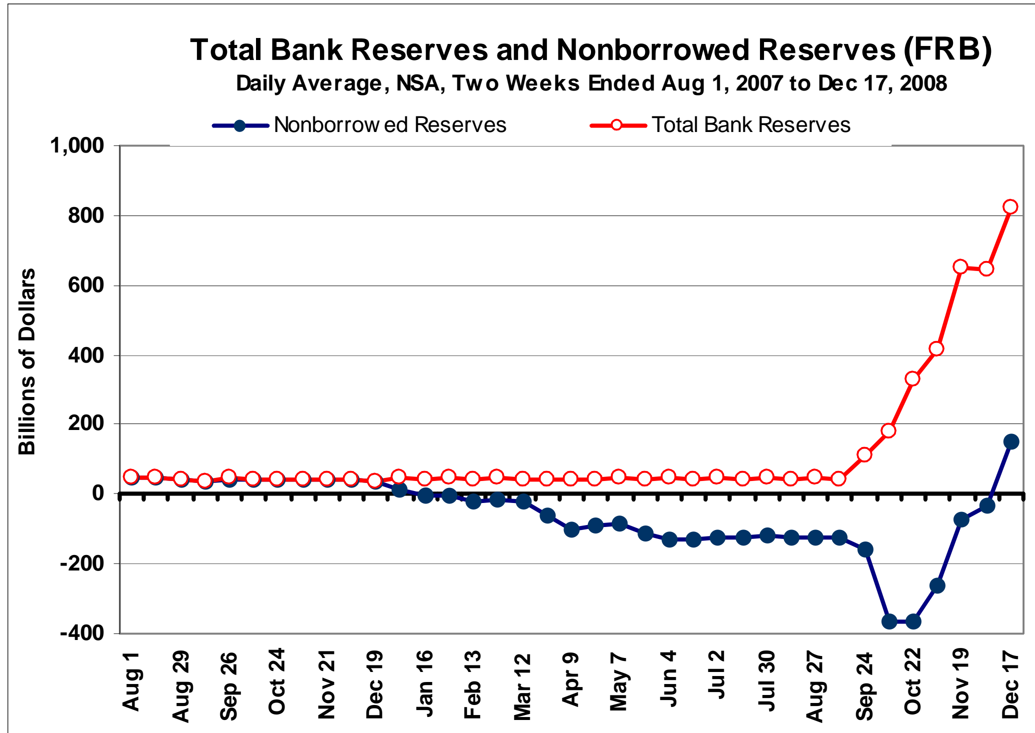
As discussed in the Reporting/Market Focus, the U.S. government effectively is bankrupt. Yet, extreme fiscal stimulus appears to be likely early in the upcoming Obama Administration, along with a further sharp and immediate increase in U.S. Treasury funding needs. As U.S. and global investors increasingly shun investment in U.S. Treasuries, the Federal Reserve will be forced to monetize that debt, as the lender of last resort to the U.S. government. Accordingly, what likely will become in 2009 the worst U.S. consumer inflation in living memory, increasingly will have the potential to evolve into hyperinflation before the end of the New Year. The estimated timing for the onset of the hyperinflationary great depression discussed in the *Hyperinflation Special Report* of April 8, 2008 has been narrowed to a range of 2009 to 2014.

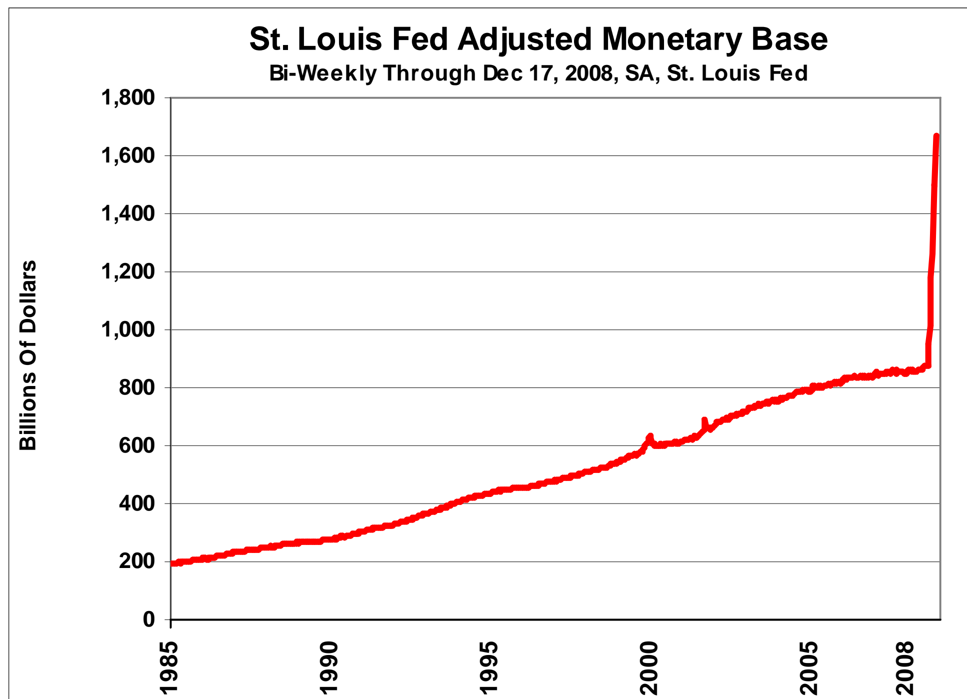
Monetary Excesses Continue. As shown in the following graphs, total reserves of depository institutions (FRB, not seasonally adjusted) have continued to surge, rising to $824.1 billion in the two weeks ended December 17th, from $645.6 billion in the prior period, and from $44.2 billion as recently as September 10th. (Late reporting shows total reserves at $856.1 billion in the two weeks ended December 31st). The increase in nonborrowed reserves just means that banks have been placing their cash in reserves faster than the Fed has been lending (the Fed pays interest now on reserves).

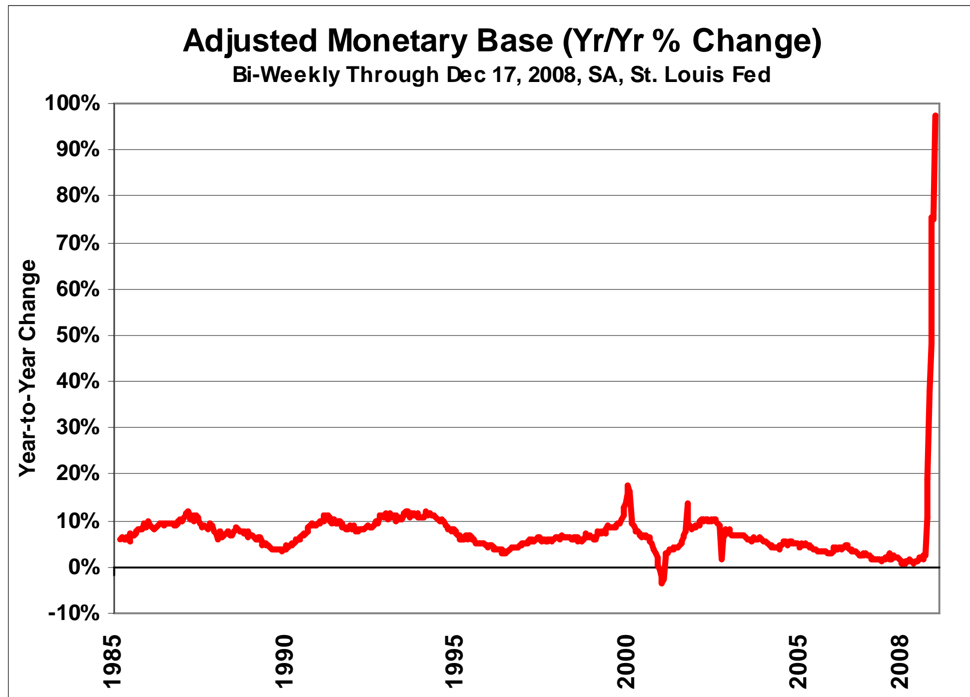
Where most of the growth has continued to be in excess reserves, such suggests that the banks generally have not resumed fully-normal lending. Of significance, though, required reserves have been holding above $53 billion, at $53.2 billion in the two weeks ended December 17th ($53.8 in the December 31st period), up from $41.9 billion in the two weeks ended September 10th. Annual growth in required reserves has spiked to 32.0% (as reflected in the graph) and is growing at the fastest pace of the post-World War II era. This indicates that the excess reserves have started entering the system, albeit slowly, but at a pace fast enough to spike broad money growth in December.

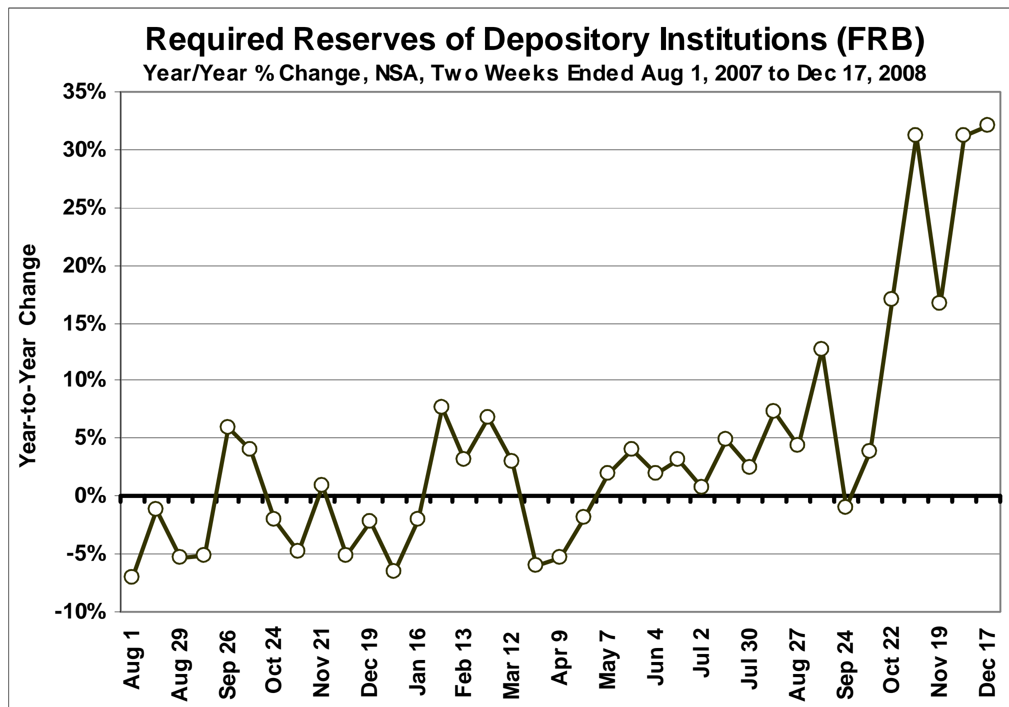
The seasonally-adjusted St. Louis Fed Monetary Base -- the Fed's traditional tool for adjusting money supply growth -- has continued to spike thanks to the growth in reserves. The monetary base basically includes the currency component of M1 and total bank reserves. Year-to-year growth for the two weeks ended December 17th was a record 97.5%, as shown in the graph. Late reporting for the December 31st period shows annual growth of 99.4%.

Fed apologists offer assurances that the U.S. central bank will dry up excess liquidity when the solvency crisis passes, with no net impact on money supply growth or inflation prospects. Assurances also are being put forth that the surge in government borrowing will be absorbed happily by the usual forced lenders, and that the Fed will not have to monetize Treasury debt further.


Total Bank Reserves and Nonborrowed Reserves (FRB)
Daily Average, NSA, Two Weeks Ended Aug 1, 2007 to Dec 17, 2008
Nonborrowed Reserves
Total Bank Reserves
Billions of Dollars
1,000
800
600
400
200
0
-200
-400
Aug 1
Aug 29
Sep 26
Oct 24
Nov 21
Dec 19
Jan 16
Feb 13
Mar 12
Apr 9
May 7
Jun 4
Jul 2
Jul 30
Aug 27
Sep 24
Oct 22
Nov 19
Dec 17


St. Louis Fed Adjusted Monetary Base
Bi-Weekly Through Dec 17, 2008, SA, St. Louis Fed
Billions Of Dollars
1,800
1,600
1,400
1,200
1,000
800
600
400
200
0
1985
1990
1995
2000
2005
2008

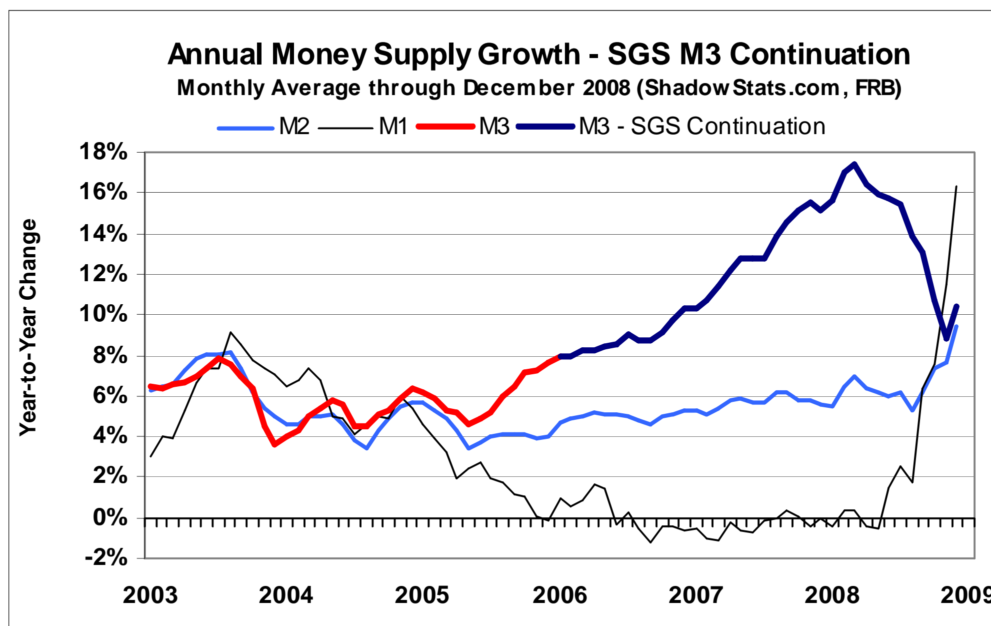




Copyright 2009 Shadow Government Statistics, www.shadowstats.com

Such is nonsense! Money growth has started to accelerate, and there is little that can be done to build global confidence in U.S. Treasuries and the U.S. dollar, given the recent and promised new debasement of the U.S. currency. The Fed is not going to try to collapse money growth with declining economic activity already entering depression. The Fed faces a liquidity trap. It can get the money supply to grow and inflation to spike, but it will not be able to get the economy to rally.

M3 Annual Growth Rebounds. Based on a continuing weekly pickup in key M3 components, the pattern of slowing annual growth seen in the SGS-Ongoing M3 Measure, since April, appears to have bottomed at 8.9% in November. With roughly three weeks of December data in hand, the year-to-year change in the seasonally-adjusted M3 average is estimated to have rebounded to roughly 10.4%. The month-to-month increase in the series -- estimated at roughly 2.3% -- more than offsets the two month-to-month declines seen in October and November. These estimates will be revised in the next two weeks as more-complete information becomes available.



As bank lending went into a deep freeze and individuals moved to cash or Treasury bills in the unfolding financial panic, not only did annual growth in the broad money supply slow, but also the velocity of money -- the speed with which cash turned over in the economy -- likely dropped off sharply.

Now, the financial crisis would appear to have calmed to the point that investors are starting to take cash out of their mattresses, and that banks are beginning to lend somewhat more normally. Given the recent excesses of Fed activity, as reflected in soaring annual growth in bank reserves -- particularly required reserves -- and the monetary base, flow-through to the annual growth in the broad money supply -- as reflected in the

Copyright 2009 Shadow Government Statistics, www.shadowstats.com

SGS-Ongoing M3 Measure -- likely will surge to the highest levels seen since before the creation of the Federal Reserve in 1913. As bank lending increasingly returns towards normal functioning, and as cash comes out of the mattresses, the velocity of money also should increase. In conjunction with the rising broad money growth, increasing velocity will offer intensified upside pressure on consumer inflation (see the August 3rd *Money Supply Special Report* for background).

Implications are for a significant pickup in consumer inflation by mid-2009 -- despite a severe economic contraction -- with likely negative impact on the exchange rate for the U.S. dollar, and likely positive impact on precious metals prices and prices for dollar-denominated commodities such as oil.

Worst Economy Since the Great Depression. Whatever comes forth in the Obama Administration's economic stimulus package likely will have more of a positive impact on the general economy than did mailing taxpayers direct cash payments in 2008. The checks to taxpayers hardly created a blip in retail sales and did nothing to address the structural issues in the economy. If the promised stimulus indeed is aimed at creating new employment, the impact would be slower in surfacing, but it could have some dampening effect on the contraction, if the funding of the package can be sold to the global markets.

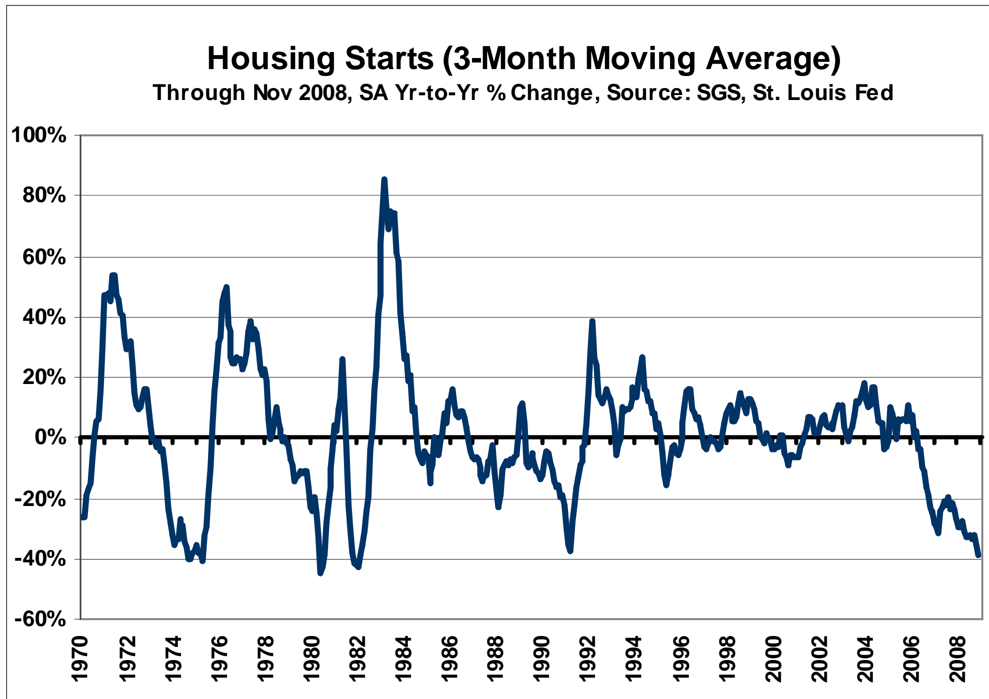
Putting aside philosophical issues as to the relative merits or demerits of the U.S. government increasingly attempting to direct U.S. corporate and/or economic activity (I would argue strongly against such a trend), the new Administration's biggest problems could be with the credit markets, as discussed in the Reporting/Market Focus.

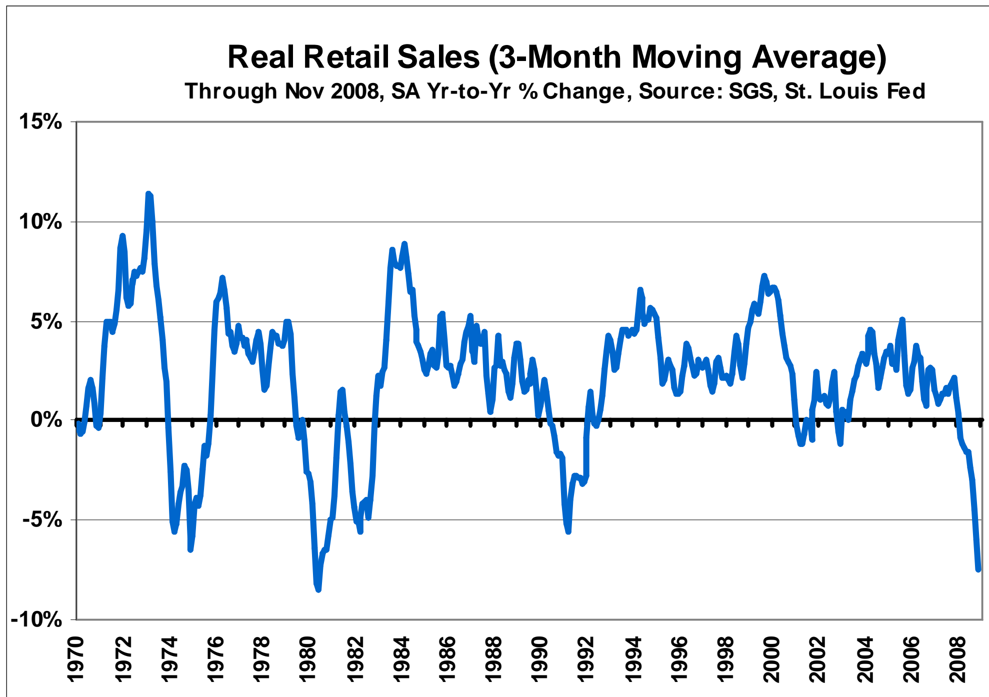
Getting to the current state of the economy, the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER) -- official arbiter of whether or not the U.S. economy is in recession -- has determined that the U.S. economy peaked in December 2007 and has been in recession since. I argued in the previous newsletter and still contend that the current downturn began in fourth-quarter 2006, a year earlier than the official start. The current downturn is the second downleg of what will become a multiple-dip depression/great depression (again, *SGS Newsletter No. 47* of November 14, 2008 is included here by reference). Economies do not contract in perpetual plunges -- they bounce or bottom-bounce -- and the pending stimulus package conceivably could help trigger such a bottom-bounce, setting the stage for the next downleg in the structural downturn.

The financial press and Wall Street, of course, will stick with the official version of economic activity, but even that should shift to comparisons with the Great Depression by mid-year. Against its official starting point, the current recession has been ongoing for 13 months and shows no signs of imminent bottoming, where such would be used to mark the recession's end. By April 2009, the recession will be timed as the longest since the Great Depression (its current 13 months ties the length of the second-dip of the Great Depression in that late 1930s), where, at present, its length was exceeded by the 1973 to 1975 recession and by the second leg of the double-dip recession of the early 1980s.

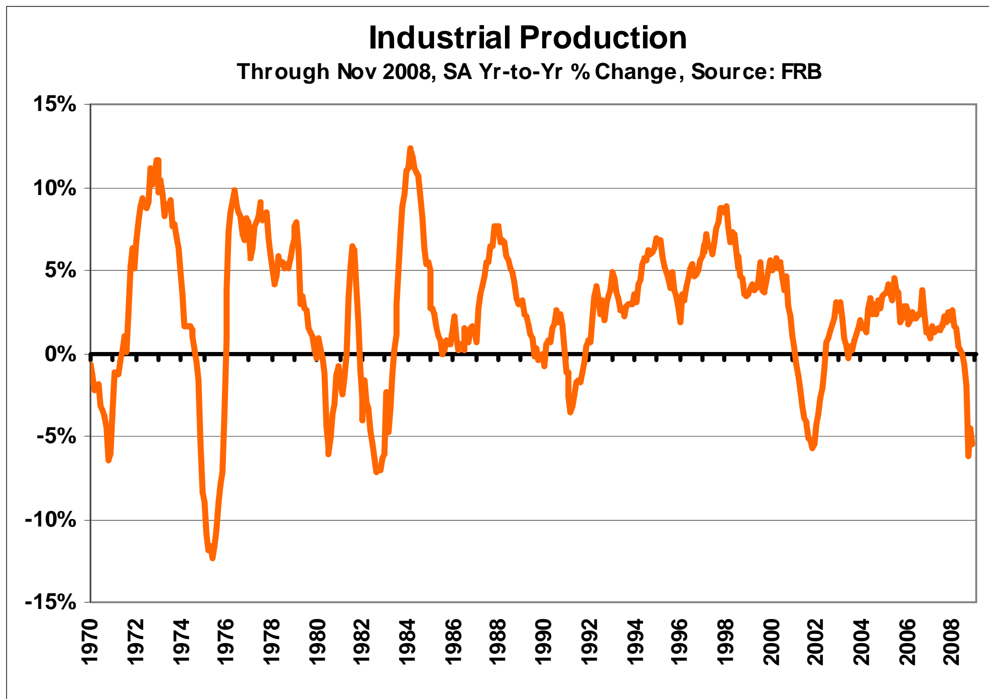
As shown in the accompanying charts of annual growth in key economic indicators, current economic activity already is at the lowest levels seen since the mid-1970's and early-1980's downturns (except for payrolls, which likely will be there in the next monthly reporting).

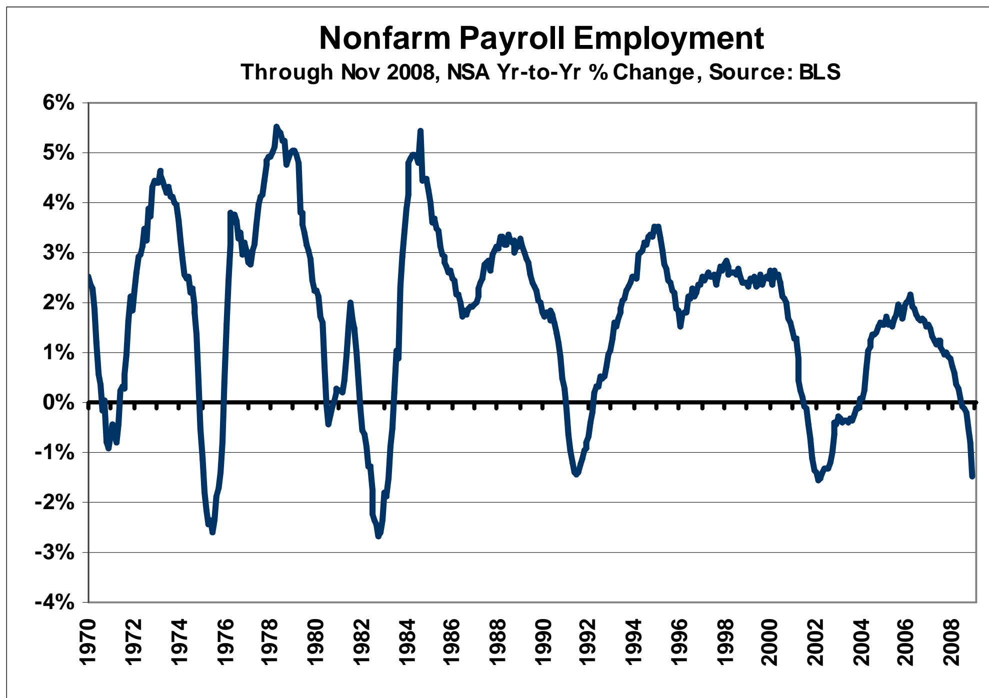
It is worth noting that shy of the Concurrent Seasonal Factor Bias (also graphed), which has been increasing in recent monthly headline reports of payrolls, the annual payroll contraction reflected in the annual-change graph already might be in the range of the earlier severe recessions (see the Employment comments in the Reporting Section).



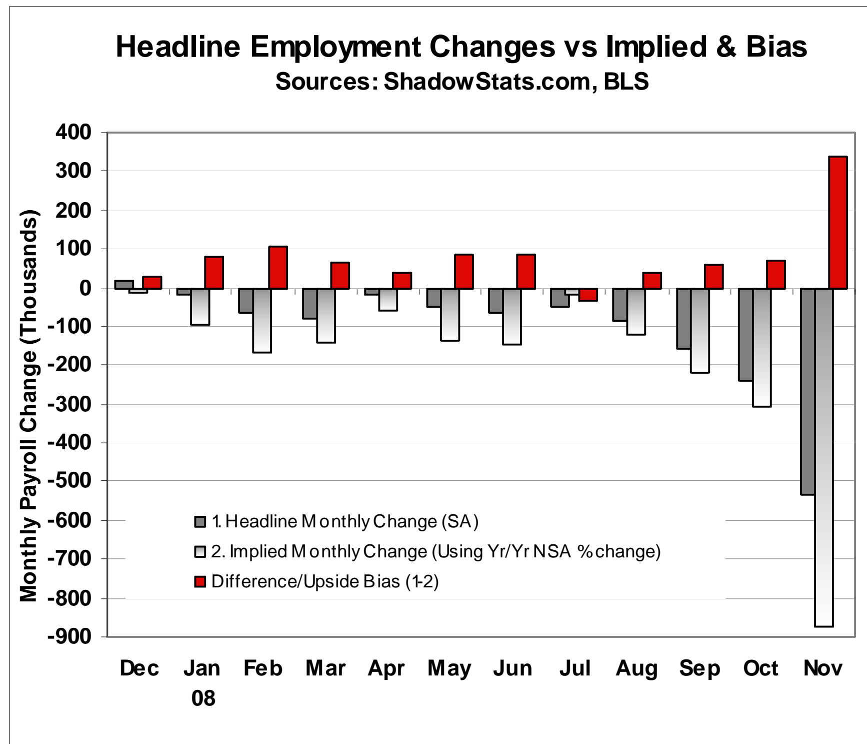


Copyright 2009 Shadow Government Statistics, www.shadowstats.com





Copyright 2009 Shadow Government Statistics, www.shadowstats.com



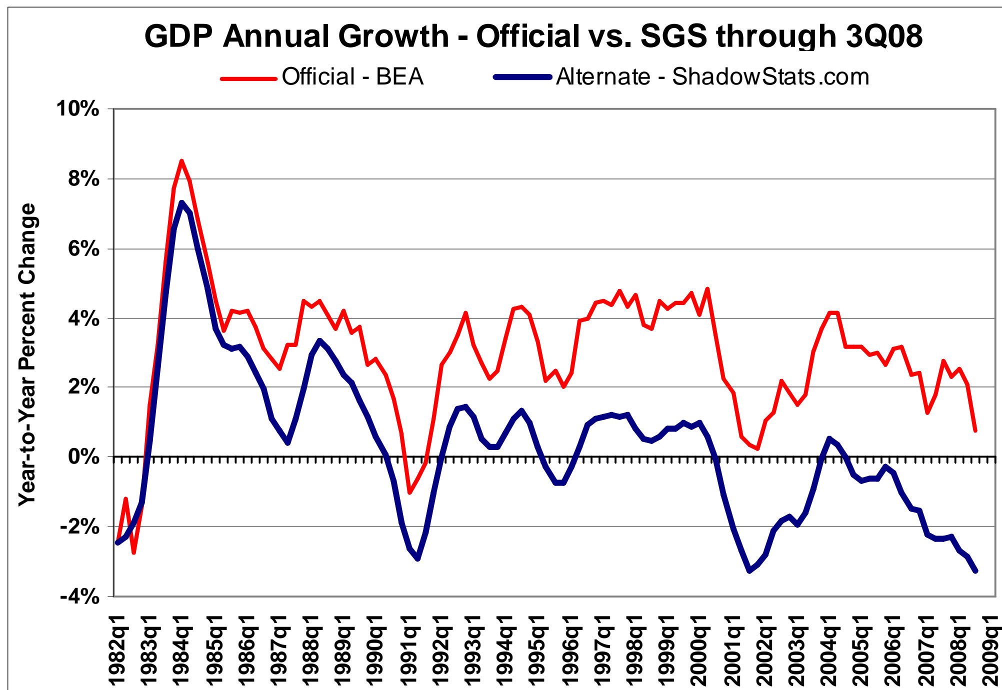
By April, all the indicators graphed should be showing new lows in economic activity. Using various measures, both of the major earlier-period contractions have been touted as the weakest economies since the Great Depression. With extreme duration and extreme contraction in place by April, the current "recession" should take on the title as the "weakest economy" since the Great Depression.

Yesterday's purchasing managers manufacturing survey for the month of December suggests that the mantle already may have been passed. The key index components of production and new orders fell to their lowest levels ever, since January 1948, suggesting the weakest economy since the Great Depression and the production shutdown following World War II. Also, for the fourth quarter, new orders for durable goods are plunging at an annualized rate of 37%.

Using my SGS-Alternate GDP and my definition of depression -- a peak-to-trough contraction in inflation-adjusted economic activity that exceeds 10% -- the current downturn should qualify as a depression in the year ahead. Inflation will pick-up in the same time frame. At such time as hyperinflation kicks in (possibly in 2009), normal commerce would tend to cease, and economic activity would tumble into a great depression, with a peak-to-trough downturn exceeding 25%.

PLEASE NOTE: *A* ***"General background note"*** *provides a broad background paragraph on certain series or concepts. Where the language used in past and subsequent newsletters usually has been or will be identical, month-after-month,* ***any text changes in these sections will be highlighted in bold italics upon first usage.*** *This is designed so that regular readers may avoid re-reading material they have seen before, but where they will have the material available for reference, if so desired.*

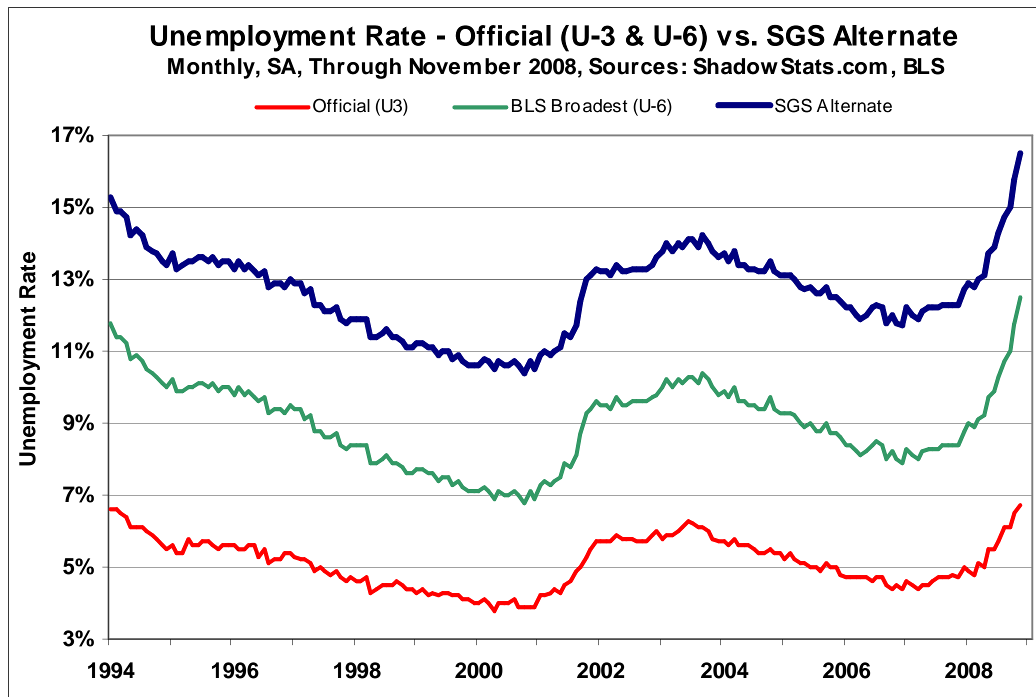
Alternate Realities. This section updates the Shadow Government Statistics (SGS) alternate measures of official GDP, unemployment and CPI reporting. When a government economic measure does not match common public experience, it has little use outside of academia or the spin-doctoring rooms of the Federal Reserve, White House and Wall Street. In these alternate measures, the effects of gimmicked methodological changes have been removed from the official series so as to reflect more accurately the common public experience, as embodied by the pre-Reagan-Era CPI and GDP and the pre-Clinton Era unemployment rate. Methodologies for the GDP and CPI series are discussed in the August 2006 SGS.



GDP. The alternate third-quarter 2008 GDP growth reflects the "final" estimate revision, with many of the methodological gimmicks of recent decades removed. The alternate third-quarter inflation-adjusted annual growth rate (year-to-year, as opposed to the popularly-touted annualized quarter-to-quarter rate) for GDP was a decline of roughly 3.3% versus the official year-to-year gain of 0.7%. The official, annualized real quarter-to-quarter change stands at a 0.5% contraction. While the quarterly growth number is popularly followed, its significant inaccuracies are expanded to the fourth-power in reporting. The alternate measure safely would have shown an annualized quarterly contraction in the third quarter, in excess of two-percent.

General background note: Historical data on both the official and SGS-Alternate GDP series are available for download on the Alternate Data page of www.shadowstats.com. The Alternate GDP numbers tend to show deeper and more protracted recessions than have been reported formally or reflected in related official reporting. Nonetheless, the patterns shown in the alternate data are broadly consistent with the payroll employment and industrial production series, which are major indicators used by the National Bureau of Economic Research in determining the official timing of U.S. business cycles.

Copyright 2009 Shadow Government Statistics, www.shadowstats.com



Unemployment Rate. Shown are two official seasonally-adjusted unemployment measures, U.3 and U.6, and the SGS-Alternate Unemployment Measure. The various measures moved sharply higher again in November, reflecting rapidly deteriorating labor-market conditions. The November rates stood respectively at 6.7%, 12.5% and 16.5%, up from 6.5%, 11.8% and 15.8% in October.

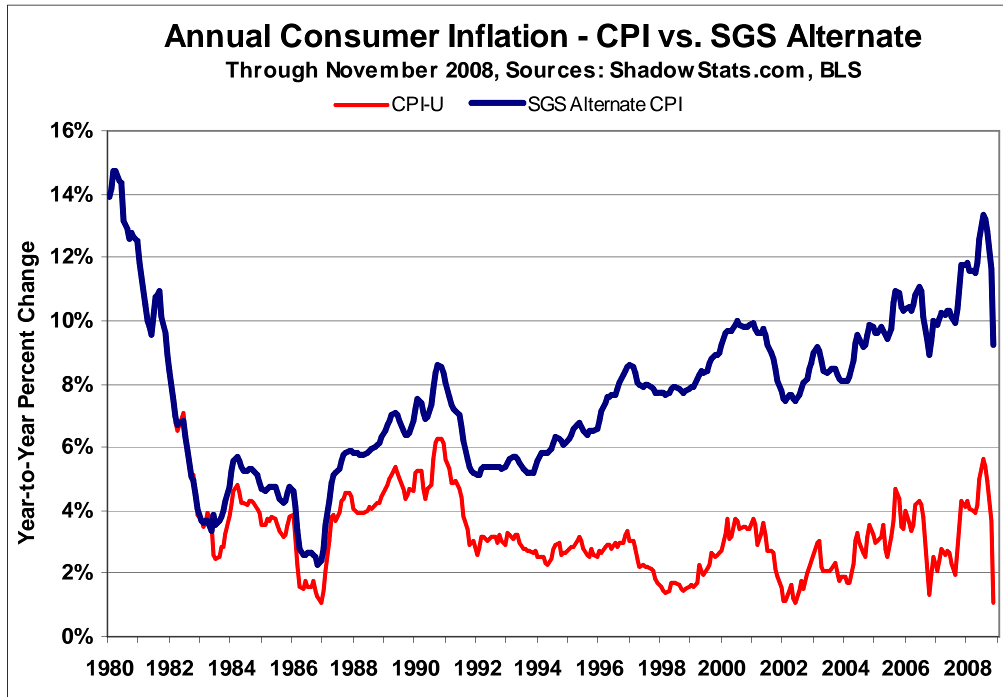
General background note: U.3 is the popularly followed unemployment rate published by the Bureau of Labor Statistics (BLS), while U.6 is the broadest unemployment measure published by the BLS. U.6 is defined as total unemployed, plus all marginally attached workers, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all marginally attached workers. Marginally attached workers include the discouraged workers who survived redefinition during the Clinton Administration. The SGS-Alternate Unemployment Measure simply is U.6 adjusted for an estimate of the millions of discouraged workers defined away during the Clinton Administration -- those who had been "discouraged" for more than one year.

General background note: Historical data on both the official and SGS-Alternate unemployment series are available for download on the Alternate Data page of www.shadowstats.com. The Alternate numbers are reported from the 1994 series redefinitions forward. It is planned to take the alternate series further back in time.

CPI. Absorbing continued sharp declines in energy prices, November's annual full inflation rates eased sharply, while "core" inflation softened as well. Curiously, the PCE Deflator (I.4 in the accompanying table), which tends to track closely with the C-CPI-U (I.5), showed annual inflation easing from 3.2% in October to 1.4% in November, while the C-CPI-U dropped from 3.3% to 0.7%. Such is suggestive of conflicting issues in handling the energy cost decline in the government's various inflation measures.

Shy of the upcoming, further energy-related battering in December, annual inflation generally should be bottoming out, with much higher inflation seen by mid-2009. Renewed dollar weakness, renewed acceleration in broad money growth and a likely bottoming in energy prices, all should combine with existing inflationary pressures from the ongoing flow-through impact of energy-cost damages still working through the general economy, and from the upside inflation pressures from monetary growth in place before the systemic solvency crisis.

General background note: Historical data on both the official and SGS-Alternate CPI series are available for download on the Alternate Data page of www.shadowstats.com. The Alternate CPI numbers tend to show significantly higher inflation over time, generally reflecting the reversal of hedonic adjustments, geometric weighting and the use of a more traditional approach to measuring housing costs, measures all consistent with the reporting methodology in place as of 1980. Available as a separate tab at the SGS homepage www.shadowstats.com is the SGS Inflation Calculator that calculates the impact of inflation between any two months, 1913 to date, based on both the official CPI-U and the SGS-Alternate CPI series.



Eight Levels of Consumer Inflation
Annual Inflation for August to November 2008

Measure		Aug	Sep	Oct	Nov
I.1	Core PCE Deflator (r)	2.4%	2.3%	2.0%	1.9%
I.2	Core Chained-CPI-U	2.2%	2.2%	1.9%	1.6%
I.3	Core CPI-U	2.5%	2.5%	2.2%	2.0%
I.4	PCE Deflator (r)	4.4%	4.1%	3.2%	1.4%
I.5	Chained-CPI-U	4.7%	4.3%	3.3%	0.7%
I.6	CPI-U	5.4%	4.9%	3.7%	1.0%
I.7	Pre-Clinton CPI-U	8.7%	8.3%	6.9%	4.4%
I.8	SGS Alternate Consumer Inflation	13.2%	12.9%	11.6%	9.3%

(r) Revised.
Notes: I.1 to I.3 reflect the core inflation rates, respectively, of the substitution-based personal consumption expenditure (PCE) deflator, the Chained-CPI-U and the geometrically-weighted CPI-U. I.4 to I.6 are the same measures with energy and food inflation included. The CPI-U (I.6) is the measure popularly followed by the financial press, when the media are not hyping core inflation. I.7 is the CPI-U with the effects of geometric weighting (Pre-Clinton Era as estimated by SGS) reversed. This is the top series in the CPI graph on the SGS home page www.shadowstats.com. I.8 reflects the SGS Alternate Consumer Inflation measure, which reverses the methodological gimmicks of the last 25 years or so, plus an adjustment for the portion of Clinton-Era geometric weighting that is not otherwise accounted for in BLS historic bookkeeping.

For the rest of this issue of the Newsletter, visit http://www.shadowstats.com/article/397