

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

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General Update

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Real Disposable Income on Track for Second-Quarter Contraction

An Unlikely U.S. Default Would Hit Dollar and Accelerate Inflation

New Action to Depress Officially Reported Inflation?

PLEASE NOTE: Today's Commentary reviews general conditions in a week devoid of major economic releases. Accordingly there is no Reporting Detail section, although the general implications of items such as reported disposable income and consumer confidence—often of poor quality or limited significance—are included in the general assessment of consumer conditions.

The next regular Commentary is scheduled for Friday, July 8th. It will cover details of the June employment and unemployment report.

—Best wishes for a Happy Fourth of July! —John Williams

Opening Comments. The economy continues to falter, while—at the same time—inflation continues to increase. Consumer liquidity problems are worsening, while the inflation problem persists. Despite near-term volatility in oil prices, the effects of higher oil costs increasingly permeate the broad economy, and

the U.S. dollar continues under selling pressure. Accordingly, any relative weakness in oil or other U.S. dollar-based commodity prices likely should be short-lived.

At the same time, talk mounts of allowing an unnecessary default on U.S. debt (see the *Hyperinflation Watch* section). Such a default would be a serious mistake, and it most likely will be avoided as political games push the limits of brinksmanship. An outright default likely would trigger massive dumping of the U.S. dollar, and it would accelerate movement to much higher U.S. inflation and, ultimately, to hyperinflation. The deficit cuts being discussed are too small to save the system, and they may include a new redefinition of the consumer price index (CPI) solely for purposes of creating artificial reductions in official inflation reporting and in related cost-of-living adjustments for Social Security, etc.

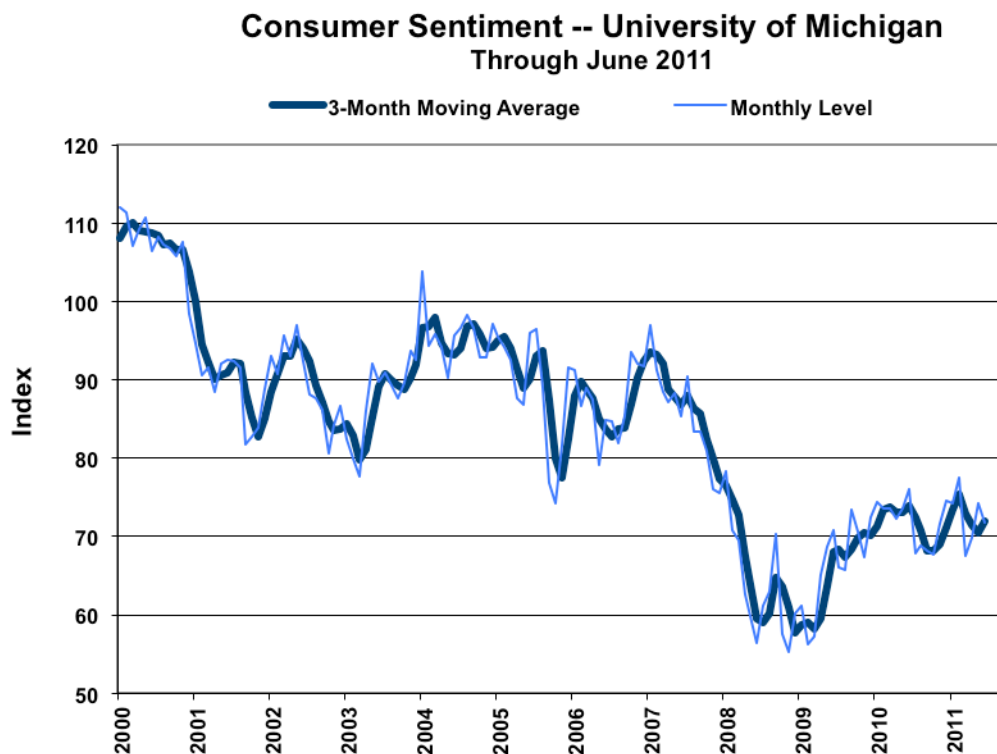
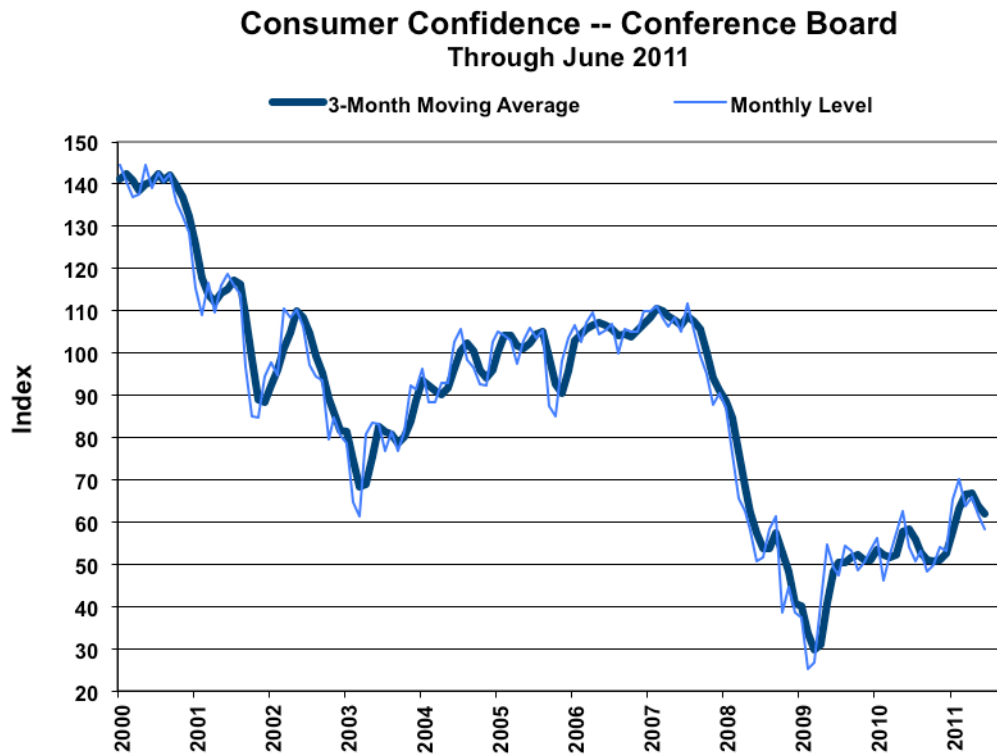
Structural Consumer Income and Liquidity Issues Prevent Sustainable Economic Rebound. U.S. consumers are unable to support sustained economic expansion at present and for the foreseeable future. Personal consumption and residential investment accounted for 71.3% of the gross domestic product (GDP, the government's not-too-meaningful broad measure of economic activity) as estimated for first-quarter 2011. Aside from the 20.6% of GDP attributed to federal- and local-government consumption, the bulk of the remainder of GDP activity ultimately is based on underlying personal consumption.

U.S. households have faced an increasingly difficult structural impediment to income during the last 40 years, with income growth failing to keep pace with inflation. The problems have accelerated in the last decade, where real (inflation-adjusted) median household income (adjusted by the heavily gimmicked CPI-U-RS series) as reported in the latest *Poverty Report*, was lower in 2009 than it was before the 2001 recession. Adjusted for the more commonly used CPI-U headline inflation, 2009 median household income also was below what it was in 1973. The loss of higher paying production jobs to offshore competition has been a primary cause here of declining income. This topic is discussed more fully in the [*Hyperinflation Special Report \(2011\)*](#).

Even with Bureau of Economic Analysis (BEA) regular overstatement of income, and understatement of inflation, reported real disposable income (effectively take-home pay) is shrinking per official reporting. The BEA's *Personal Income and Outlays: May 2011* (released June 27th) showed real disposable income in May 2011 to be virtually unchanged versus December 2010 (a five-month increase of less than 0.1%), with the two-month average, so far, for second-quarter 2011 below the average of the first-quarter 2011. Usually, when official real disposable income turns negative, the GDP is not far behind.

Indeed, without sustained positive real growth in income, sustained positive real growth in the broad economy is not possible. Short-term growth, however, can be borrowed from the future with debt expansion. Former Federal Reserve Chairman Alan Greenspan encouraged excessive debt expansion for more than a decade, at least partially for that reason. In the wake of the current credit collapse and systemic solvency crisis, though, most consumers no longer have that option.

Consumer credit outstanding recently has shown some seasonally-adjusted monthly growth, but all the gain has been in government lending to students, not from banks lending to purchasing consumers. Even if debt expansion were available for general consumption, the consumer would have to be willing to borrow and to spend. That willingness is lacking, to a certain extent, based on the latest consumer confidence and sentiment numbers plotted in the following graphs (the June number on consumer sentiment is the preliminary estimate).



While these confidence numbers traditionally are viewed as leading indicators, they tend to be more coincident or even lagging to economic activity. Based on the nature of the surveys conducted, the results tend to reflect what consumers are hearing in the popular media. Nonetheless, both series continue at levels never seen outside of recessions.

No sustainable economic recovery is possible until the structural problems limiting consumer liquidity are resolved. There is nothing on the horizon—no activity by the federal government or by the Federal Reserve—that offers any near-term prospect even for addressing the structural issues. With the economy falling into another dip in a double- or multiple-dip recession, the federal deficit will spike much more than expected (all deficit projections, including those for the next 10 years, are based on positive economic growth). With the politicians already posturing for the 2012 election, efforts for new near-term stimulus likely will arise, irrespective of current political sensitivities related to deficit spending. A failing economy also intensifies the systemic solvency crisis, and the Fed most likely will be there with some form of overt or covert QE3.

Hyperinflation Watch—Pending Default on U.S. Treasuries? The U.S. government always has avoided and can avoid defaulting on its debt due to the debt ceiling. The Congress and the President simply act to raise the debt ceiling, although political games often are played right down to the wire. Whatever comes of the deficit-reduction talks linked to the current circumstance, it likely will not be too meaningful. With GAAP (generally accepted accounting principles) accounting showing an actual annual shortfall in government operations of \$4 to \$5 trillion per year, a cut of \$4 trillion over a period of 10 years or so is a plus, but not particularly significant. To the extent there is any precedent with the current Congress, the last attempt at budget negotiations was little more than hype and accounting gimmicks in the end. Accounting gimmicks can do wonders with such agreements, including the use of overly-optimistic economic assumptions.

A formal default on U.S. debt is unlikely. It would reflect malfeasance at the highest levels of the government. If there were a default, it most likely would be a disaster for the financial markets, with the potential for crashing the U.S. dollar, spiking interest rates and rapidly accelerating the pace of inflation.

One thing to watch for in any deficit-reduction deal is a rumored switch from using the CPI-W in calculating cost-of-living adjustments for Social Security, etc., to using the Chained-CPI-U (C-CPI). The C-CPI is a fully substitution-based inflation measure, and would complete the process, accelerated in the 1990s by the Boskin Commission, to change the CPI from a measure of the cost-of-living of maintaining a constant-standard-of-living to a substitution-based measure. In the new measure, if steak prices rise sharply, and people shift to buying hamburger as a result, inflation is reduced accordingly by that switch (see the [Response to BLS ...](#)).

The BLS may have some logistical problems with such a change. For example the BLS revises the C-CPI regularly, which it never does with the unadjusted CPI because of use of the CPI in contracts, etc. Where this type of change would have some distorting impact on the public's view of the actual inflation rate for purposes of income maintenance or targeted investment returns, it would be better generally for the system if the politicians just admitted that they were cutting Social Security payments and put forth meaningful inflation numbers.

The broad inflation and economic outlooks discussed in the [*Hyperinflation Special Report \(2011\)*](#) continue unabated.

Week Ahead. Though still not widely acknowledged, there is both an intensifying double-dip recession and a rapidly escalating inflation problem. Until such time as financial-market expectations fully catch up with underlying reality, reporting generally will continue to show higher-than-expected inflation and weaker-than-expected economic results in the month and months ahead. Increasingly, previously unreported economic weakness should show up in prior-period revisions.

Employment and Unemployment (June 2011). The report on June labor conditions is due for release on Friday, July 8th. Consensus forecasts may be less positive than seen in recent months, based on last month's "surprise" weakness and ongoing indications of a softening economy. Nonetheless, reporting risks still favor negative surprises versus likely market expectations. At work here is not only a renewed downturn in economic activity, but also some likely catch-up from recent poor-quality reporting that resulting from heavily distorted seasonal-factor adjustments. A resumption of outright monthly contraction in nonfarm payrolls and an upside spike in the headline U.3 unemployment rate remain fair bets to surface within the next month or two. Indeed, those results are possible in the upcoming June report.
