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

HYPERINFLATION SPECIAL REPORT

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Inflationary Recession Is in Place

Banking Solvency Crisis Has Opened First Phase of Monetary Inflation

Hyperinflationary Depression Remains Likely As Early As 2010

Overview

The U.S. economy is in an intensifying inflationary recession that eventually will evolve into a hyperinflationary great depression. Hyperinflation could be experienced as early as 2010, if not before, and likely no more than a decade down the road. The U.S. government and Federal Reserve already have committed the system to this course through the easy politics of a bottomless pocketbook, the servicing of big-moneyed special interests, and gross mismanagement.

The U.S. has no way of avoiding a financial Armageddon. Bankrupt sovereign states most commonly use the currency printing press as a solution to not having enough money to cover their obligations. The alternative would be for the U.S. to renege on its existing debt and obligations, a solution for modern sovereign states rarely seen outside of governments overthrown in revolution, and a solution with no happier ending than simply printing the needed money. With the creation of massive amounts of new fiat (not backed by gold) dollars will come the eventual complete collapse of the value of the U.S. dollar and related dollar-denominated paper assets.

What lies ahead will be extremely difficult and unhappy times for many. Ralph T. Foster, in his "Fiat Paper Money" (see recommended further reading at the end of this issue), closes his book's preface with a particularly poignant quote from a 1993 interview of Friedrich Kessler, a law professor at Harvard and University of California Berkeley, who experienced 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."

This *Special Report* updates and expands upon the three-part *Hyperinflation Series* that began with the *December 2006 SGS Newsletter*, exploring: (1) the causes and background of the evolving hyperinflation and great depression; (2) why circumstances will differ from the deflationary Great Depression of the 1930s; (3) implications for politics and the financial markets; (4) considerations for individuals and businesses.

The broad outlook has not changed during the last year. More generally, though, developments in the economy and the financial markets have been in line with projections and have tended to confirm the unfolding disaster. Specifically, the current inflationary recession has gained much broader recognition, while the still-unfolding banking solvency crisis has confirmed the Fed's and the U.S. government's willingness to spend whatever money they have to create in order to keep the financial system from imploding. While the dollar has taken a heavy hit -- down roughly 20% against key currencies from last year -- selling of the U.S. currency still has been far short of the outright dollar dumping that eventually will lead to flight to safety outside of the U.S. dollar. That event is important to the shorter-term timing of the pending hyperinflation.

Regular readers may recognize text from last year's *Series*, as well as material from various SGS newsletters, but such is the nature of revisions to prior material. Points that may be repeated from earlier newsletters are done so in sequence to help build the arguments explaining the unfolding crisis. Great thanks are extended to the numerous subscribers who offered ideas, questions and materials that have been incorporated in this report.

Defining the Components of a Hyperinflationary Great Depression

Deflation, Inflation and Hyperinflation. Inflation generally is defined in terms of a rise in general prices due to an increase in the amount of money in circulation. The inflation/deflation issues defined and discussed here are as applied to goods and services, not to the pricing of financial assets.

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 10-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, in Hungary after World War II and in the dismembered Yugoslavia of the early 1990s.

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

Foster (see recommended further reading at the end of this issue) details the history of fiat paper currencies from 11th century Szechwan, China, to date, and their consistent collapses, time-after-time, due to what appears to be the inevitable, irresistible urge of issuing authorities to print too much of a good thing. The United States is no exception, already having obligated itself to liabilities well beyond its ability ever to pay off.

Here are the definitions:

Deflation. A decrease in the prices of goods and services, usually tied to a contraction of money in circulation.

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

Hyperinflation: Extreme inflation, minimally in excess of four-digit annual percent change, 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 than as currency.

As discussed in the section Historical U.S. Inflation: Why Hyperinflation Instead of Deflation, 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 gold standard in 1933. The era of the modern fiat dollar generally has been one of persistent and slowly debilitating inflation.

Recession, Depression and Great Depression. A couple of 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, 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." 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 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, the worst post-World War II recession was from November 1973 through March 1975, with a peak-to-trough contraction of 5%. Such followed the Vietnam War, Nixon's floating of the U.S. dollar and the Oil Embargo. The double-dip recession in the early-1980s may have seen a combined contraction of roughly 6%. I contend that the current double-dip recession that began in late-2000 already is rivaling the 1980s double-dip as to depth. (See the Reporting/Market Focus of the October 2006 SGS for further detail.) *Please note that the definition for "great depression" below has been revised to a contraction in excess of 25% (from 20% stated in the March 16, 2008 newsletter), in order to be consistent with the usage in last year's* Series.

Here are the definitions:

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.

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%.

On the basis of 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 the somewhat broader "great depression" definition of a contraction in excess of 20% (instead of 25%), the depression of 1837 to 1843 would be considered "great," as technically would be the war-time production shut-down in 1945.

The current economic contraction is about halfway towards being classified as a "depression," based on my definitions and GDP accounting. As the Great War became World War I with the advent of World War II, so too may the Great Depression become Great Depression I, as the current crisis reaches its full, terrible potential. As with the two world wars, what may become known as Great Depression II had its roots in Great Depression I.

Current Environment

Before examining how the current circumstance can evolve from an inflationary recession to a hyperinflationary depression and then great depression, it is worth defining the nature of the current economic and inflation conditions in the United States, and likely near-term developments.

Based on the regular material discussed in the *SGS Newsletter*, the U.S. economy is in an inflationary recession as will be reported in official statistics. Real (inflation-adjusted) fourth-quarter 2007 GDP, in July's benchmark revision, and/or first-quarter 2008 GDP should be in contraction, with most underlying economic series showing distressed levels of activity consistent with a recession. Annual CPI inflation is at 4.0% and headed higher. Oil prices remain over $100 per barrel, weakness in the dollar is just beginning to impact the CPI, and the inflationary effects of soaring broad money growth should start to surface around mid-year. Official CPI could be running in double-digits by year-end 2008.

Net of gimmicked methodologies that have reduced CPI inflation reporting and inflated GDP reporting, the U.S. economy has been in a recession since late-2006, entering the second down-leg of a multiple-dip economic contraction, where the first downleg was the recession of 2001 that really began back in late-1999. Annual CPI inflation currently is running around 11.6%, again, facing further upside pressures.

The current outlook does not exclude further bounces and dips in economic activity. As was seen during the Great Depression, in severe contractions the economy can hit bottom and then bounce briefly until it falls again, finding a new bottom. As discussed in the Depression/Great Depression section, the current economic downturn reflects a structural shift, which increasingly has constrained consumer activity during the last several decades, and which cannot be turned quickly. The current downturn, by my numbers, already is halfway to qualifying as a depression. The evolving depression quickly will move to great depression status, when the hyperinflation hits, as such will be extremely disruptive to the conduct of normal commerce.

The efforts by the federal government and the Federal Reserve to prevent a systemic collapse as a result of the banking solvency crisis has started to spike broad money growth, as measured by the SGS-Ongoing M3 measure, which currently shows a record annual growth rate of 17.3%. While the Fed has not been formally creating new money -- yet -- by adding to reserves, it has had the effect of creating new money by re-liquefying otherwise illiquid banks, by lending liquid assets versus illiquid assets. As a result, a number of banks have been able to resume more normal functioning, lending money and creating new money supply. As the systemic bailout proceeds, formal money creation will follow and already may be starting to show up in official accounting.

In response to the rapidly deteriorating fundamentals underlying the value of the U.S. dollar, selling of the greenback has been intense, but contained, with brief periods of stability as seen at the moment. In the near future, dollar selling should build towards an extreme, with heavy foreign investment in the dollar fleeing the U.S. currency for safety elsewhere. With the domestic financial markets and U.S. Treasuries so heavily dependent on foreign capital for liquidity, the Federal Reserve -- now touted as the formal financial market stabilizer -- will be forced increasingly to monetize federal debt. That process will build over time, given the federal government's effective bankruptcy, as discussed in the section U.S. Government Cannot Cover Existing Obligations. Therein lies the ultimate basis for the pending hyperinflation.

Again, the current circumstance will evolve into a hyperinflationary depression, then great depression. Although such is not likely much before 2010, or after 2018, that financial end game for the current markets will tend to come sooner rather than later and will break with surprising speed when it hits. As discussed later, this likely will not be a deflationary environment as seen during the Great Depression.

What lies ahead for the current year will be severe enough and financially painful enough to affect the outcome of the 2008 presidential election. Historically, the concerns of the electorate have been dominated by pocketbook issues. Prior to gimmicked methodologies making the reporting of disposable personal income largely meaningless, that measure was an excellent predictor of presidential elections.

In every presidential race since 1908, in which consistent, real (inflation-adjusted) annual disposable income growth was above 3.3%, the incumbent party holding the White House won every time. When income growth was below 3.3%, the incumbent party lost every time. Again, with redefinitions to the national income accounts in the last two decades, a consistent measure of disposable income as reported by the government has disappeared. Yet, even with official reporting, the current annual growth in real disposable income is at 2.2%, well below the traditional 3.3% limit.

Accordingly, odds are quite high that the numbers for 2008 will favor an incumbent party loss, i.e. a victory for the Democrats. Where I always endeavor to keep my political persuasions separate from my analyses, for purposes of full disclosure, my background is as a conservative Republican with a libertarian bent.

What follows or coincides politically with a hyperinflationary depression offers a wide variety of possibilities, but the political status quo likely would not continue. Times would be financially painful enough to encourage the development of a third party that could move the Republicans or Democrats to third-party status in the 2010 mid-term or 2012 presidential elections.

Historical U.S. Inflation: Why Hyperinflation Instead of Deflation

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.

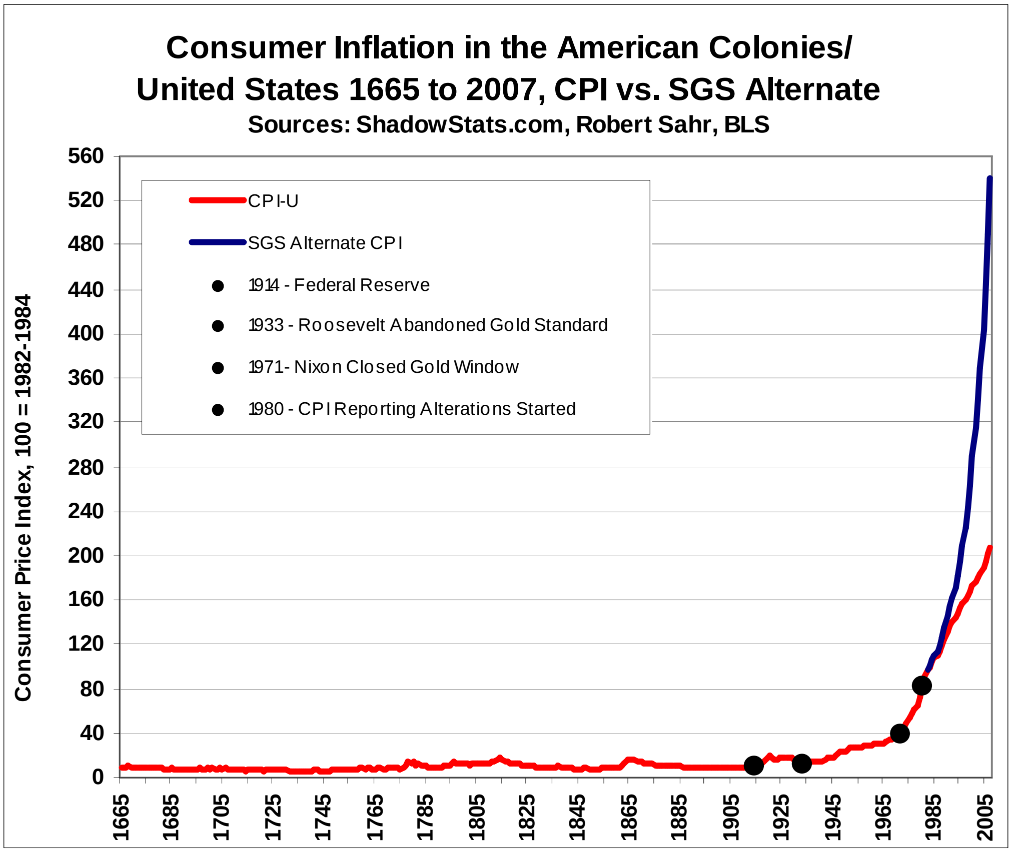
-- Robert Frost

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 monetary discipline formerly imposed on the system by the gold standard, and a Federal Reserve dedicated to preventing a collapse in the money supply and the implosion of the still, extremely over-leveraged domestic financial system.

The accompanying two graphs measure the level of consumer prices since 1665 in the American Colonies and later the United States. The first graph 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 Franklin Roosevelt's abandoning of the 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 SGS-Alternate Measure of Consumer Prices in the last several decades. 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 SGS based, as indicated.

The magnitude of the increase in price levels in the last 50 years or so, however, visually masks in the first graph the inflation volatility of the earlier years. That volatility becomes evident in the second graph, with inflation history shown only through 1960.

What is shown in the second graph is that up through the Great Depression, regular periods of inflation -- usually seen around wars -- have been offset by periods of deflation. 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.

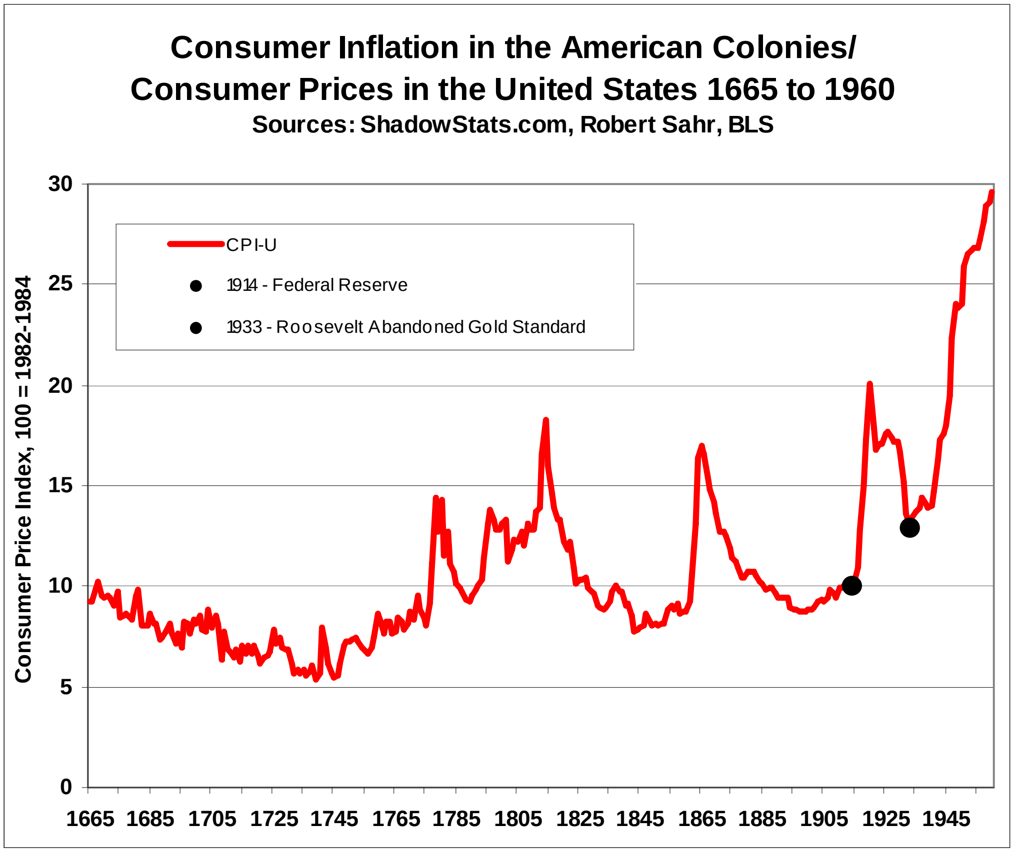


The inflation peaks and the ensuing post-war depressions and deflationary periods tied to the War of 1812, the Civil War and World War I show close to 60-year cycles, which is part of the reason some economists and analysts have been expecting a deflationary depression in the current period. There is some reason behind 30- and 60-year financial and business cycles, as the average difference in generations in the U.S. 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.

Aside from minor average annual price level declines in 1944 and 1955, the United States has not seen a 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.

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, partially due to the monetary discipline imposed by the gold standard, Franklin Roosevelt used those issues as an excuse to abandon gold and to adopt close to a fully fiat currency under the auspices of what I call the debt standard, where the government effectively could print and spend whatever money it wanted to.



Roosevelt's actions were against the backdrop of the banking system being in a state of collapse. The Fed stood by twiddling its thumbs as banks failed and the money supply imploded. A depression collapsed into the Great Depression, with intensified price deflation. Importantly, a sharp decline in broad money supply is a prerequisite to goods and services price deflation. Messrs Greenspan and Bernanke are students of the Great Depression period. As did Mr. Greenspan before him, "Helicopter Ben" has vowed not to allow a repeat of the 1930s money supply collapse.

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 explained in his remarks: "I am confident that the Fed would take whatever means necessary to prevent significant deflation in the United States ..." As a quick point of clarification, Mr. Bernanke's actions to address the current banking system's solvency issues are still in the preventative phase. The money supply is not in collapse, and the Fed has not started dropping cash from helicopters, yet, but the choppers are in the air and remain at the ready.

As expounded upon by Mr. 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." The full text of then-Fed Governor Bernanke's remarks can be found at: http://federalreserve.gov/boarddocs/speeches/2002/20021121/default.htm.

Where Franklin Roosevelt abandoned the gold standard and its financial discipline for the debt standard, eleven successive administrations have pushed the debt standard to the limits of its viability, as seen now in the ongoing threat of possible systemic collapse. The effect of these policies has been a slow-motion destruction of the U.S. dollar's purchasing power, as seen in the accompanying table, since the gold standard was abandoned in 1933.

Loss of U.S. Dollar Purchasing Power through March 2008

	----Since January of ----		
Versus:	**1914**	**1933**	**1970**
Swiss franc	-80.4%	-80.4%	-76.5%
CPI-U	-95.1%	-94.0%	-82.3%
Gold	-97.9%	-97.9%	-93.4%
SGS-Alternate CPI	-98.2%	-97.8%	-93.6%

Note: Gold and Swiss franc values were held constant by the gold standard versus coins in 1914 and 1933.
Sources: Shadow Government Statistics, Federal Reserve, Bureau of Labor Statistics

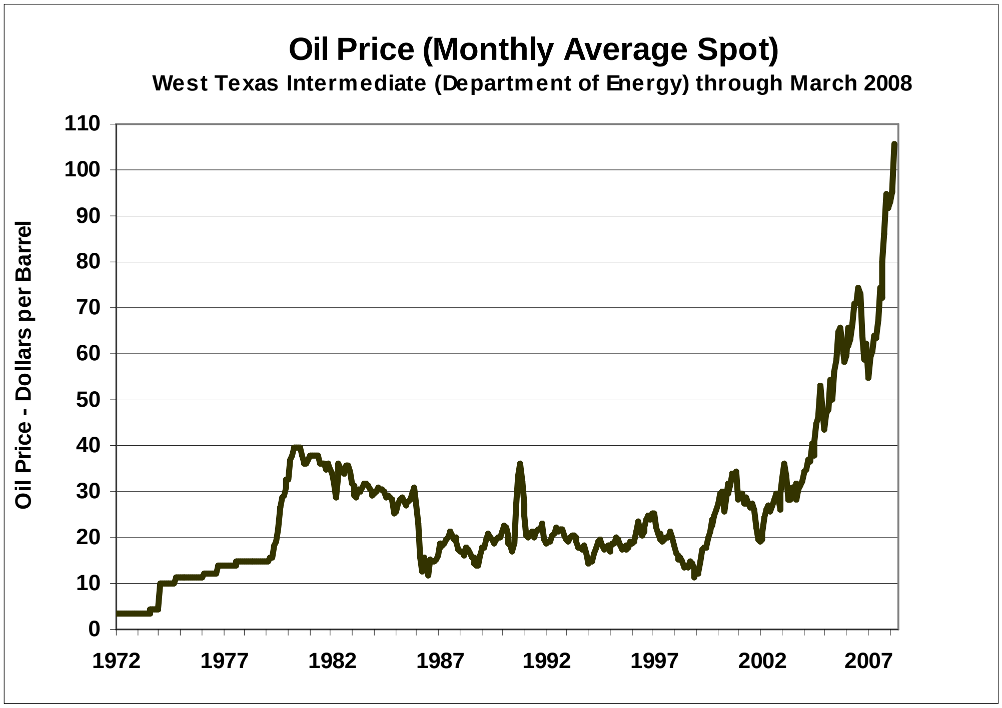
As discussed in the next section, the limits to the unlimited abuse of the debt standard are particularly evident in the GAAP-based financial statements of the U.S. government, which show the actual federal deficit at $4.0-plus trillion for 2007, alone, with total federal obligations standing at $62.6 trillion. With no ability to honor these obligations, the government effectively is bankrupt.

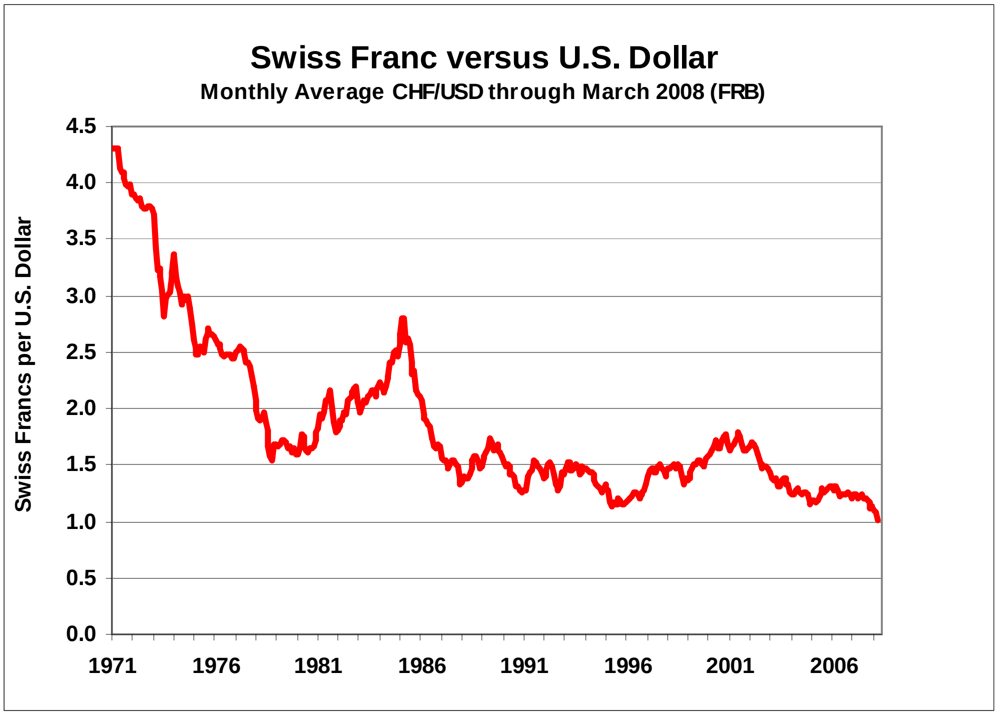
At such debt levels, the markets soon will recoil from lending Uncle Sam whatever he needs. Major buyers of U.S. Treasuries from outside the United States, including a number of central banks, already are balking. These investors have funded nearly all net U.S. Treasury debt issuance of the last five years, putting to use the excess dollars flushed into the global markets by the United States' excessive and ever-expanding trade deficit. This practice, however, generated liquidity for the U.S. markets that has helped to depress long-term Treasury yields as well as to boost equity prices, in general.

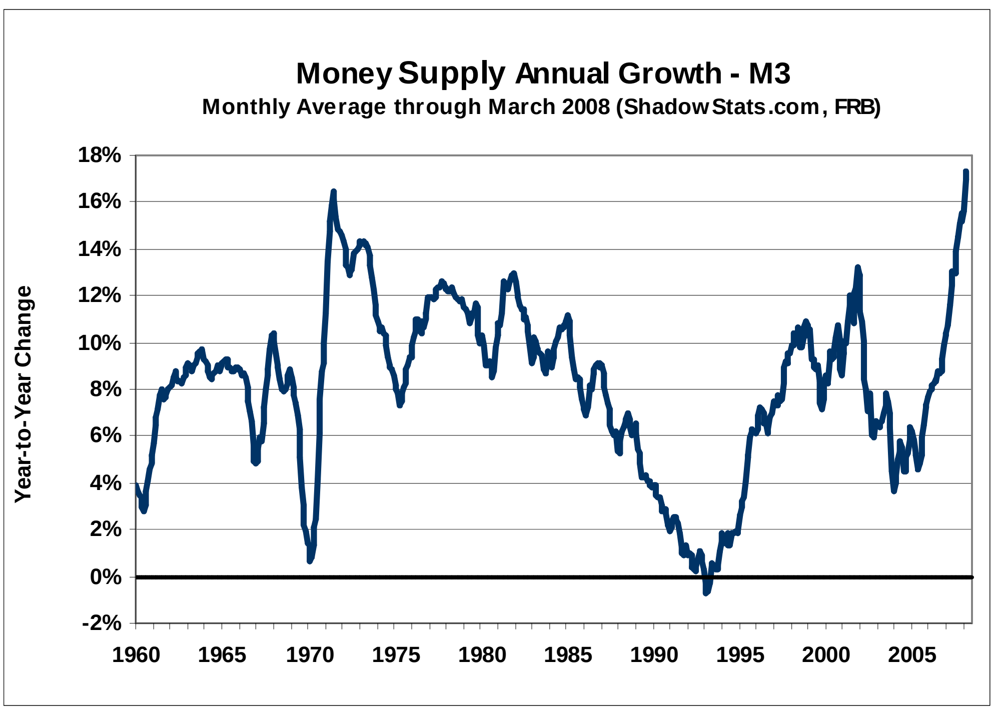
Although the U.S, government faces ultimate insolvency, it has the same way out taken by most countries faced with bankruptcy. It can print whatever money it needs to create, in order to meet its obligations. The effect of such action is a runaway inflation -- a hyperinflation -- with a resulting, effective full debasement of the U.S. dollar, the world's reserve currency. The magnitude of the loss of the U.S. dollar's purchasing power in the last 75 years now has the potential of being replicated within a few days or weeks.

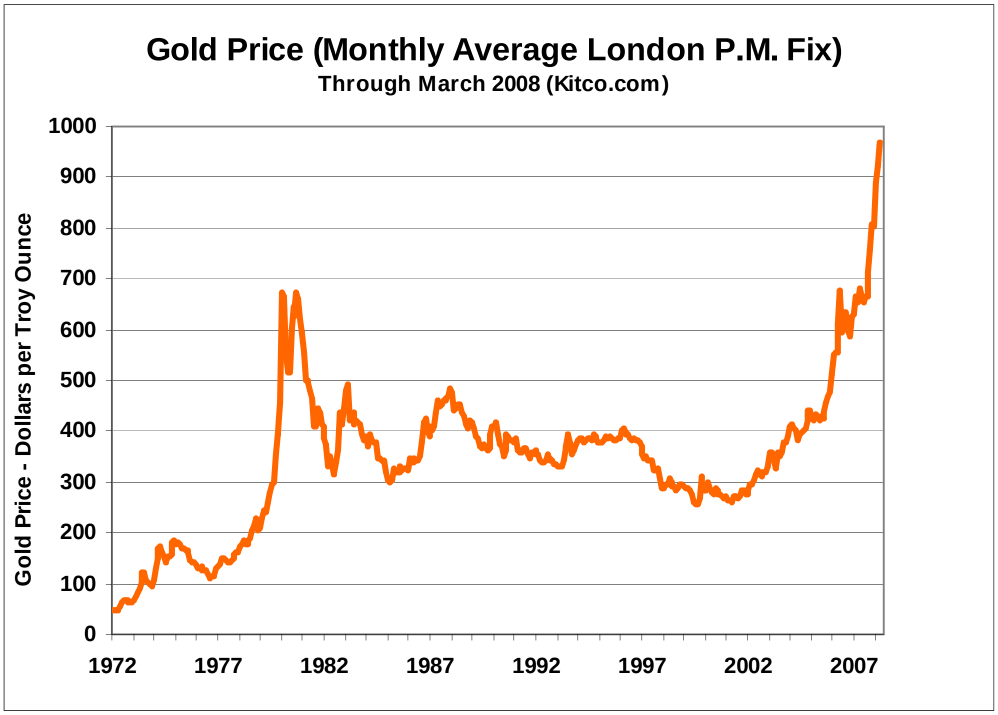
In the present environment, the chances for the collapse in money supply needed to generate a consumer price deflation are nil. First, the discipline of the gold standard that helped trigger historical deflations is gone. Second, both from the standpoint of the government's fiscal irresponsibility and from the Fed's standpoint of providing the financial system with whatever liquidity is needed to keep it afloat, the U.S. central bank already is pushing broad money growth to new extremes, not containing it.

Shown in the next four graphs are powerful fundamentals that either drive U.S. inflation or reflect market expectations of the longer-term domestic inflation outlook. Oil prices are near historic highs, the dollar is near historic lows, and money growth is at an all-time. The near-term outlook for all three series is for new record levels and for extremely strong upside pressure on U.S. inflation. Accordingly, gold prices should continue moving higher, setting new historic highs.




Swiss Franc versus U.S. Dollar
Monthly Average CHF/USD through March 2008 (FRB)
Swiss Francs per U.S. Dollar
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
1971
1976
1981
1986
1991
1996
2001
2006


Money Supply Annual Growth - M3
Monthly Average through March 2008 (ShadowStats.com, FRB)
Year-to-Year Change
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
-2%
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005



U.S. Government Cannot Cover Existing Obligations

The U.S. Treasury publishes annual financial statements of the United States Government, prepared using generally accepted accounting principles (GAAP), audited by the General Accountability Office (GAO) and signed off on by Treasury Secretary Paulson.

The statements show that the federal government's annual fiscal deficit, far from being officially in the low hundreds of billions of dollar -- although 2008 numbers rapidly are moving towards the $500 billion mark -- is careening wildly out of control, averaging $4.6 trillion dollars per year for the six years through 2007. The difference is in accounting for the net present value, and year-to-year changes in same, for unfunded Social Security and Medicare liabilities.

The government's finances not only are out of control, but the actual deficit is not containable. Put into perspective, if the government were to raise taxes so as to seize 100% of all wages, salaries and corporate profits, it still would be showing an annual deficit using GAAP accounting on a consistent basis. In like manner, given current revenues, if it stopped spending every penny (including defense and homeland security) other than for Social Security and Medicare obligations, the government still would be showing an annual deficit.

The results summarized in the following table show the various deficit/debt/obligation measures. The official GAAP-based deficit, including the annual change in the net present value of unfunded liabilities for Social Security and Medicare is estimated at more than $4.0 trillion in 2007 versus $4.6 trillion in 2006. The 2007 estimate is based on a consistent year-to-year accounting basis.

Further, contrary to the suggestion of Treasury Secretary Paulson -- aside from a weakening economic outlook discussed in the next section -- if the annual deficit is beyond containment through standard fiscal actions, then the United States has no way to grow out of this shortfall.

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

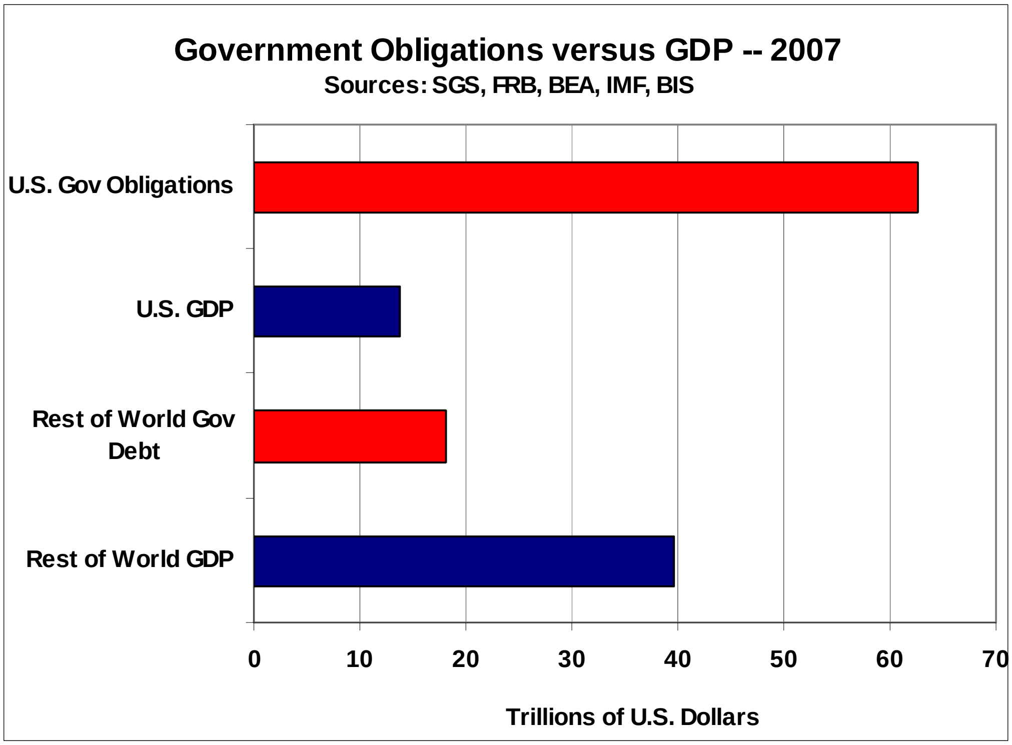
Dollars are either billions or trillions, as indicated. Sources: U.S. Treasury, Shadow Government Statistics.

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 ($Tril)	Total Federal Obilga-tions(2) (GAAP) ($Tril)
2007	$162.8	$275.5	$4.0(3)	$57.1	$9.0	$62.6
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) Revised to include gross federal debt, not just "public" debt. (3) On a consistent reporting basis, net of one-time changes in actuarial assumptions and accounting, SGS estimates that the GAAP-based deficit for 2007 topped $4 trillion, instead of the gimmicked $1.2 trillion.
(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). Link to the 2007 statements: http://fms.treas.gov/fr/07frusg/07frusg.pdf

The GAAP-accounting is what a U.S. corporation would have to show. The Administration's rationale as to why Social Security and Medicare should remain off balance sheet runs along the lines that the government always has the option of changing the Social Security and Medicare programs. That said, there clearly is no one in political Washington willing to go public with the concept of eliminating or substantially cutting those programs. Such includes the prospective presidential candidates.

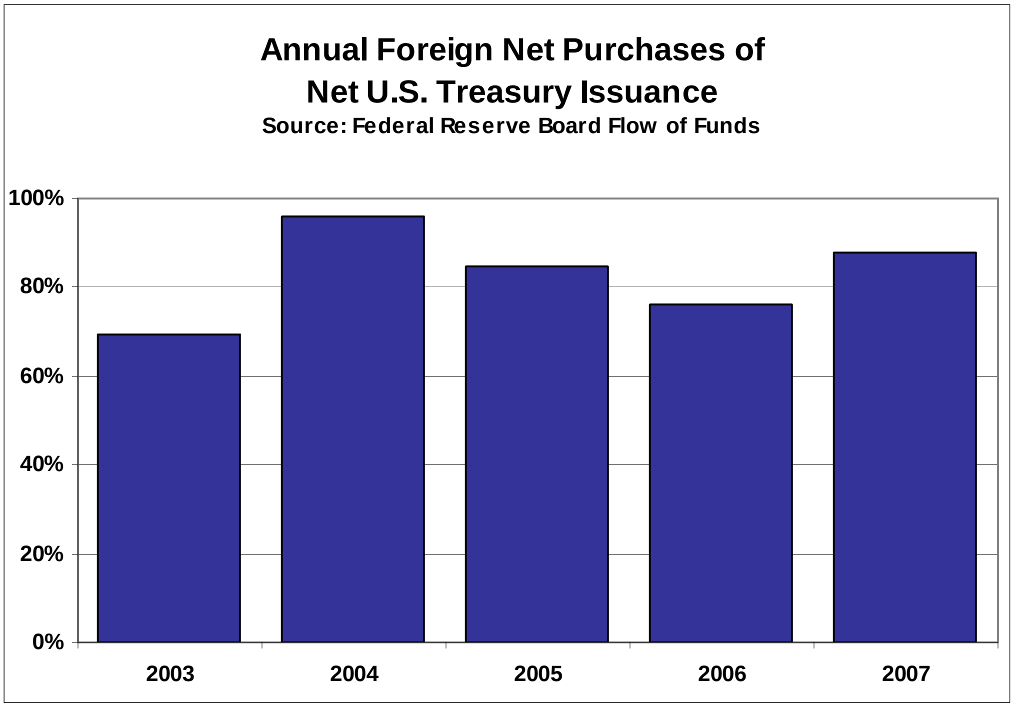
Consider that given the current financial condition of the government, various politicians are pushing ever further for expensive cradle-to-grave programs for the electorate, ranging from national health insurance to bailouts of mortgaged homeowners at risk of foreclosure. With no full funding available for any new programs, the government again is showing its willingness to spend whatever money it has to create. The intent going forward is inflation -- hyperinflation. This circumstance has evolved with the full knowledge of political Washington and the Federal Reserve.

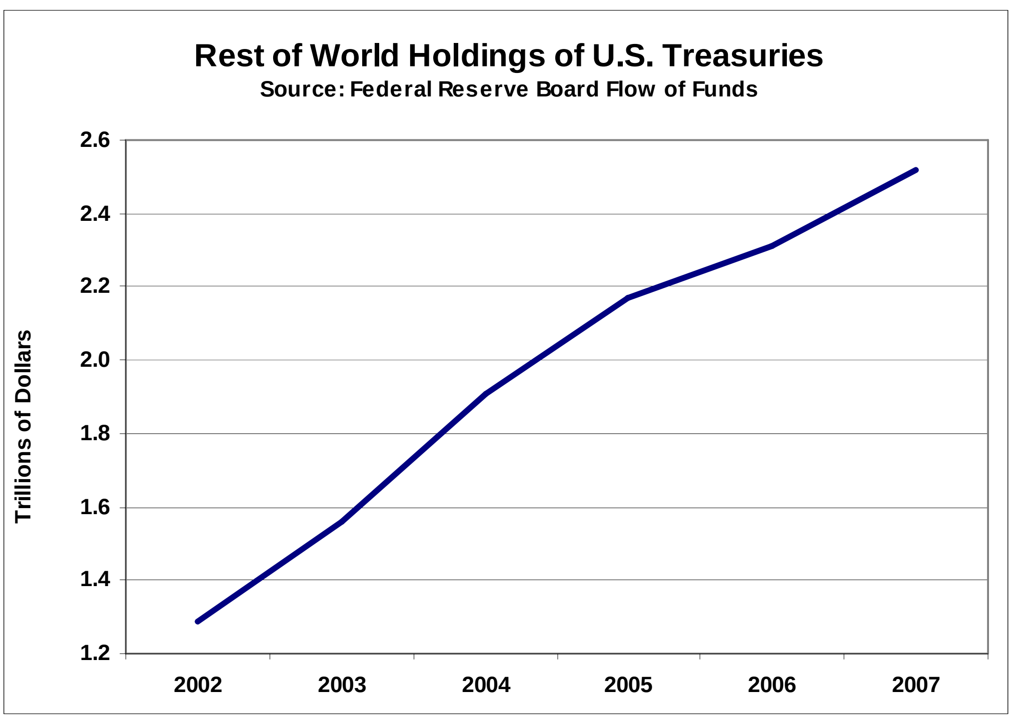


As shown in the above graph, U.S. federal obligations are so huge versus the national GDP that the country's finances look more like those of a banana republic than the world's premiere financial power and home to the world's primary reserve currency, the U.S. dollar.

If not for the special position the United States holds in the world, its debt -- U.S. Treasuries -- likely would be rated as below investment grade, instead of triple-A. Moody's has even hinted at a longer-term downgrade on Treasury securities. While a three-month Treasury bill should be safe, I would not want to bet on receiving full value on a 10-year Treasury note or 30-year Treasury bond.

Yet, as shown in the following two graphs, most U.S. Treasury issuance has been purchased by investors outside the United States. Not only have these investors been taking a hit in terms of the value of the U.S. dollar, but also they face meaningful default/devaluation risk in the future. It is only a matter of time before this accommodation of foreign investors shifts to flight to safety outside the greenback, and therein will develop the early pressures for the Fed to start becoming the lender of last resort to the federal government.


Annual Foreign Net Purchases of
Net U.S. Treasury Issuance
Source: Federal Reserve Board Flow of Funds
100%
80%
60%
40%
20%
0%
2003
2004
2005
2006
2007


Rest of World Holdings of U.S. Treasuries
Source: Federal Reserve Board Flow of Funds
Trillions of Dollars
2.6
2.4
2.2
2.0
1.8
1.6
1.4
1.2
2002
2003
2004
2005
2006
2007

Depression/Great Depression

The U.S. economy is in a deepening structural change that has resulted from U.S. trade policies that have driven the U.S. manufacturing base offshore. As a result, a large number of related, high paying jobs have been lost to U.S. workers.

As shown in the accompanying graphs, as the U.S. trade deficit has risen to the highest level for any country in history, U.S. average weekly earnings, adjusted for inflation, have fallen. Even using official CPI for deflation, current real earnings are below their peak back in the 1970s. Adjusted for the SGS-Alternate CPI measure, real earnings have been falling since the early 1980s. Also shown are real median incomes for U.S. males versus females, showing declines in recent years, per official government data.

The effect of this structural change has been that most consumers have been unable to sustain adequate income growth beyond the rate of inflation, unable to maintain their standard of living. The only way that personal consumption -- the dominant component of GDP -- can grow in such a circumstance is for the consumer to take on new debt or to liquidate savings. Both those factors are short-lived and have reached untenable extremes. Debt expansion and savings liquidation both were encouraged by the investment bubbles created by Alan Greenspan; he knew that economic growth could not be had otherwise. Part of what is happening today is payback for those policies.

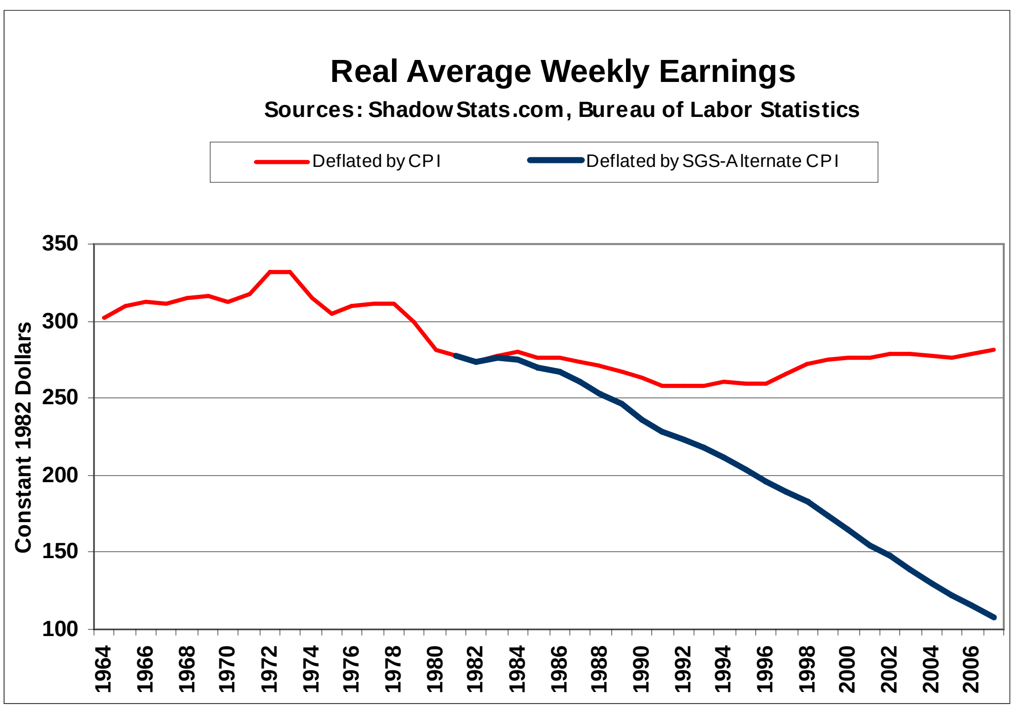
This circumstance places both the federal government and the Federal Reserve in untenable positions, where they cannot easily or rapidly address the underlying problems, even if standard economic stimuli were available. From the standpoint of the federal government, traditional fiscal stimulus in the form of tax cuts or increased federal spending have reached their practical limits, with the actual annual budget deficit running out of control at $4.0-plus trillion per year.

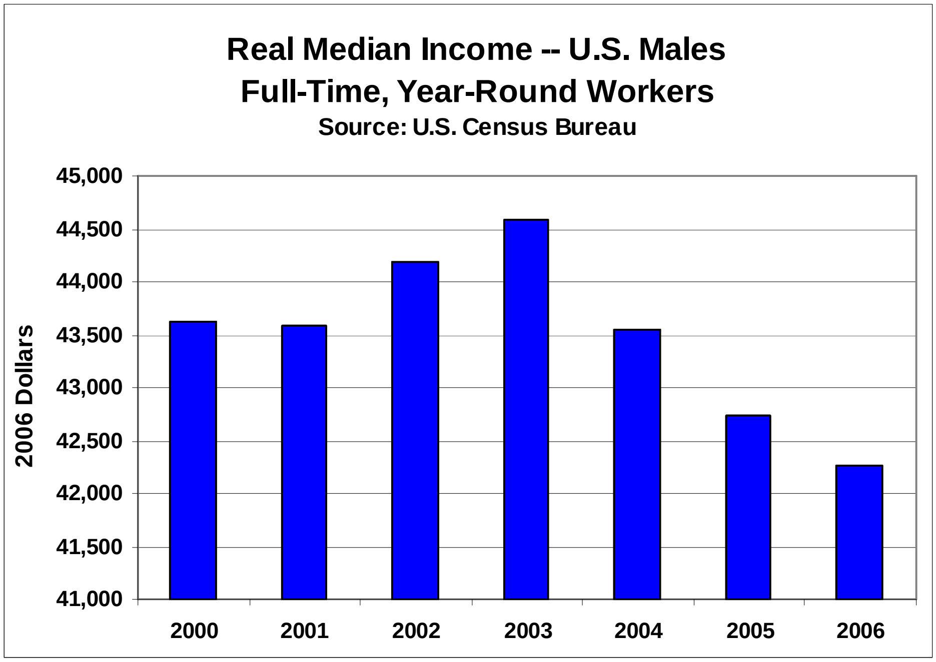
From the Fed's standpoint, it can neither stimulate the economy nor contain inflation. Lowering rates has done little to stimulate the structurally-impaired economy, and raising rates may become necessary in defense of the dollar. Similarly, raising rates will do little to contain a non-demand driven inflation, such as seen in the current circumstance that is so heavily affected by high oil prices.

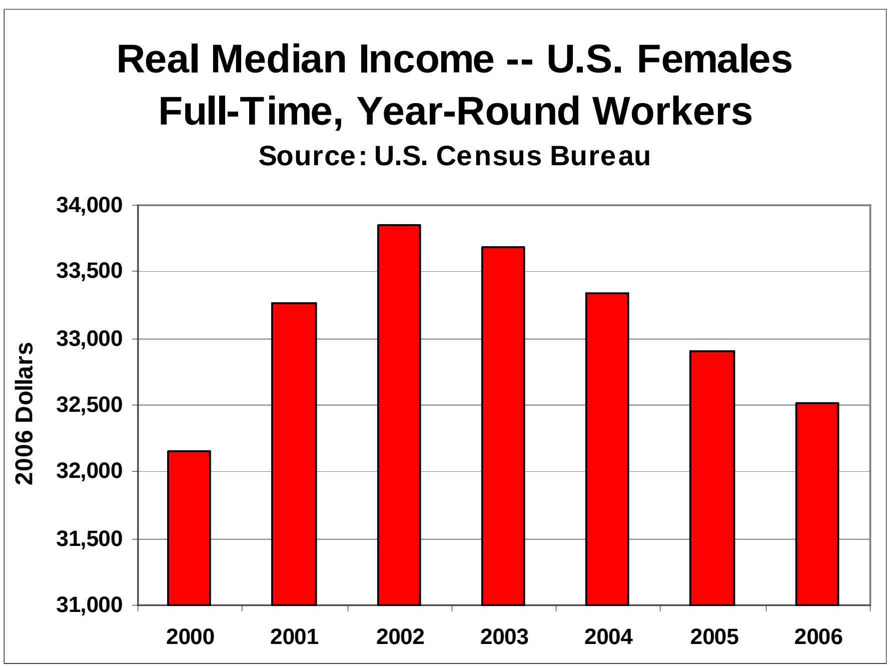
By the time hyperinflation kicks in, the economy already should be in depression, and the hyperinflation quickly should pull the economy into a great depression. Uncontained inflation is likely to bring normal commercial activity to a halt. Such is consistent with the final graph in this group, which shows household income dispersion at historic highs.

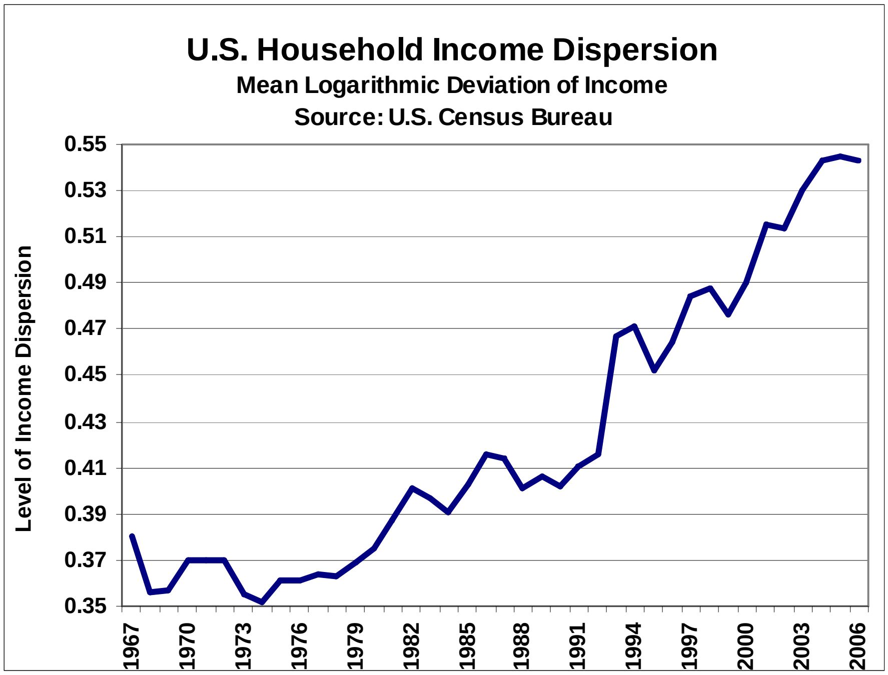
The greater the variance in income, the more negative are the longer term economic implications. A person earning $100,000,000 per year is not going to buy that many more automobiles that someone earning $100,000 per year. The stronger the middle class is, generally the stronger the economy will be. Extremes in income variance usually are followed by financial panics and economic depressions. U.S. Income variance today is higher than it was coming into 1929, and it is nearly double that of any other "advanced" economy.


U.S. Trade Balance (Net Exports) in GDP
(Seasonally Adjusted Annual Rate)
Billions of Current Dollars
100
0
-100
-200
-300
-400
-500
-600
-700
-800
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005


Real Average Weekly Earnings
Sources: ShadowStats.com, Bureau of Labor Statistics
Deflated by CPI
Deflated by SGS-Alternate CPI
Constant 1982 Dollars
350
300
250
200
150
100
1964
1966
1968
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006


Real Median Income -- U.S. Males
Full-Time, Year-Round Workers
Source: U.S. Census Bureau
2006 Dollars
45,000
44,500
44,000
43,500
43,000
42,500
42,000
41,500
41,000
2000
2001
2002
2003
2004
2005
2006


Real Median Income -- U.S. Females
Full-Time, Year-Round Workers
Source: U.S. Census Bureau
2006 Dollars
34,000
33,500
33,000
32,500
32,000
31,500
31,000
2000
2001
2002
2003
2004
2005
2006



Hyperinflationary Great Depression

In the United States, the printing presses have not been revved up heavily, yet, but the commitments are in place, as seen in the annual GAAP-based deficit running on average more $4.0 trillion per year. That amount is far beyond the ability of the government to tax or the political willingness of the government to cut entitlement spending. While the inevitable inflationary collapse, based solely on these funding needs, could be pushed well into the next decade, actions already taken likely have set the stage for a much earlier crisis.

The current systemic bailout being worked at all costs by the Federal Reserve and the U.S. government, as well as earlier efforts by the Fed to buy time have, made the circumstance worse. Pushing recent Treasury funding needs on foreign investors -- stuck with excess dollars from the ever-expanding U.S. trade deficit -- has created a huge dollar overhang in the markets that already has started to crumble. The more the crisis has been pushed into the future, the greater the potential for pending calamity has become.

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 were 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 recent foreign capital influx to the United States has helped stabilize the equity and credit markets of recent years. Following the Civil War, however, the underlying economy had significant untapped potential and was able to generate strong, real economic activity that covered the spending excesses of the war.

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)."

The Weimar circumstance is closer to the current U.S. circumstance, although, in certain aspects, the current situation is worse. Unlike the untapped economic potential of the United States 140 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.

In the early 1920s, foreign investors were not propping up the world's reserve currency in an effort to prevent a global financial collapse, knowing in advance that they were doomed to take a large hit on their investments in Germany. In today's environment, both central bank and major private investors know that the dollar is going to be a losing proposition. They either expect and/or hope that they can get out of the dollar in time to lock in their profits, or, primarily in the case of the central banks, that they can forestall the ultimate global economic crisis.

It is this environment that leaves the U.S. dollar open to potentially such a rapid and massive decline, and dumping of U.S. Treasuries, that the Federal Reserve would be forced to monetize significant sums of Treasury debt, triggering the early phases of a monetary inflation. In this environment annual multi-trillion dollar deficits rapidly would feed into a vicious, self-feeding cycle of currency debasement and hyperinflation.

Lack of Physical Cash. The United States in a hyperinflation would experience the quick disappearance of cash as we know it. Shy of the rapid introduction of a new currency and/or the highly problematic adaptation of the current electronic commerce system to new pricing realities, a barter system is the most likely circumstance to evolve for regular commerce. Such would make much of the current electronic commerce system useless and add to what would become an ongoing economic implosion.

Some years back, I happened to be in San Francisco, having dinner with a former regional Federal Reserve Bank president and the chief economist for a large Midwestern bank. Market rumors that day had been that there was a run on a major bank in the City by the Bay. So I queried the regional Fed president as to what would be happening if the rumors were true.

He had had some personal experience with a run on banks in his region and explained how the Fed had a special team designed to handle such a crisis. The biggest problem he had had was getting adequate cash to the troubled banks to cover depositors, having to fly cash in by helicopters to meet the local cash flow needs.

The troubled bank in San Francisco, however, was much larger than the example cited, and the former Fed bank president speculated that there was not enough cash in the vaults of the regional Federal Reserve Bank, let alone the entire Federal Reserve System, to cover a true run on deposits at the major bank.

Therein lies an early problem for a system headed into hyperinflation: adequate currency. Where the Fed may hold roughly \$210 billion in currency (sharply increased in the last year) outside of \$50 billion in commercial bank vault cash, the bulk of roughly \$780 billion in currency outside the banks is not in the United States. Back in 2000, the Fed estimated that 50% to 70% of U.S. dollar cash was outside the system. That number probably is higher today, with perhaps as little as $200 billion in physical cash in circulation in the United States, or roughly 1.5% of M3.

The rest of the dollars are used elsewhere in the world as a store of wealth, or as an alternate currency free of the woes of unstable domestic financial conditions. In Zimbabwe, for example, where something akin to hyperinflation is underway, U.S. dollars are used to maintain some semblance of economic activity, where wages and salaries seriously lag inflation, and goods often are available only on the black market.

Given the extremely rapid debasement of the larger denomination notes, with limited physical cash in the system, existing currency would disappear quickly as a hyperinflation broke.

For the system to continuing functioning in anything close to a normal manner, the government would have to produce rapidly an extraordinary amount of new cash, and electronic commerce would have to be able to adjust to rapidly changing prices.

In terms of cash, new bills of much higher denominations would be needed, but production lead time is a problem. Conspiracy theories of recent years have suggested the U.S. Government already has printed a new currency of red-colored bills, intended for some dual internal and external U.S. dollar system. If such indeed were the case, then there might be a store of "new dollars" that could be released at a 1-to-1,000,000 ratio, or whatever ratio was needed to make the new currency meaningful, but such would not resolve any long-term problems, unless it were part of an overall restructuring of the domestic and global financial and currency systems.

From a practical standpoint, however, currency would disappear, at least for a period of time in the early period of a hyperinflation.

Where the vast bulk of today's money is not physical, but electronic, however, chances of the system adapting here are virtually nil. Think of the time, work and effort that went into preparing computer systems for Y2K, or even problems with the recent early shift to daylight savings time. Systems would have to be adjusted for variable, rather than fixed pricing, credit card lines would need to be expanded daily, the number of digits used in tallying dollar-denominated transactions would need to be expanded sharply.

While I have been advised that a number of businesses have accounting software that can handle any number of digits, I also noted on a recent cross-country trip that a large number of gas stations have older pumps that cannot register more than two digits’ worth of dollars in their totals or more than $9.99 per gallon of gas.

From a practical standpoint, the electronic quasi-cashless society of today also would shut down early in a hyperinflation. Unfortunately, this circumstance rapidly would exacerbate an ongoing economic collapse.

Barter System. With standard currency and electronic payment systems non-functional, commerce quickly would devolve into black markets for goods and services and a barter system.

Unlike Zimbabwe, the United States does not have widely available, for circulation, a back-up reserve currency for use in place of a highly-inflated domestic currency. The alternative here is in the traditional monetary precious metals. Gold and silver both are likely to retain real value and would be exchangeable for goods and services. Silver would help provide smaller change for less costly transactions.

Other items that would be highly barterable would include bottles of a good scotch or wine, or canned goods, for example. Similar items that have a long shelf life can be stocked in advance of the problem, and otherwise would be consumable if the terrible inflation never came. Separately, individuals, such as doctors and carpenters, who provide broadly useable services, would have a service to barter.

A note of caution was raised once by one of my old economics professors, who had spent part of his childhood living in a barter economy. He told a story of how his father had traded a shirt for a can of sardines. The father decided to open the can and eat the sardines, but he found the sardines had gone bad. Nonetheless, the canned sardines had taken on a monetary value.

Reserves of the Necessities of Life. Howard J. Ruff, who has been writing about these problems and issues since Nixon closed the Gold window, rightly argues that it will take some time for a barter system to be established, and suggests that individuals should build up a six-month store of goods to cover themselves and their families in the difficult times. Mr. Ruff covers this and many other excellent fundamentals in his new book *How to Prosper During the Coming Bad Years in the 21st Century* (see recommended further reading at the end of this report).

Financial Hedges. During these times, safety and liquidity remain key concerns for investments, as investors look to preserve their assets and wealth through what are going to be close to the most difficult of times.

In such a circumstance, gold and silver would be primary hedging tools that would retain real value and also be portable in the event of possible civil turmoil. Also, at some point, the failure of the world's primary reserve currency will lead to the structuring of a new global currency system. I would not be surprised to find gold as part of the new system, structured in there in an effort to sell the system to the public.

Real estate also would provide a basic hedge, but it lacks the portability and liquidity of gold. Having some funds invested offshore -- outside of the U.S. dollar -- would be a plus in circumstances where the government might impose currency or capital controls.

While equities do provide something of an inflation hedge -- revenues and profits get expressed in current dollars -- they also reflect underlying economic and political fundamentals. I still look for U.S. stocks to take an ultimate 90% hit, peak-to-trough, net of inflation, during this period. Where all stocks are tied to a certain extent to the broad market -- to the way investors are valuing equities -- such a large hit on the broad market will tend to have a dampening effect on nearly all equity prices, irrespective of the quality of a given company or a given industry.

Other Issues. A hyperinflationary depression would be extremely disruptive to the lives, businesses and economic welfare of most individuals. Such severe economic pain could lead to extreme political change and/or civil unrest. What has been discussed here still has not been a comprehensive overview of all possible issues, but rather at least has raised some questions and touched upon some likely consequences. No one can figure out better than you the peculiarities of this circumstance and how you and/or your business might be affected. Using common sense is about the best advice I can give.

These matters will continue to be expanded upon over time in future SGSs, as circumstances and subscriber reactions continue dictate. As always, please feel free to offer your comments or raise your questions by e-mail to johnwilliams@shadowstats.com.

Recommended Further Reading

Two particularly valuable books, mentioned elsewhere in the text, are recommended to subscribers:

How to Prosper During the Coming Bad Years in the 21st Century
by Howard J. Ruff
www.rufftimes.com

Fiat Paper Money, The History and Evolution of Our Currency
by Ralph T. Foster
2189 Bancroft Way, Berkeley, CA 94704
Telephone: (510) 845-3015, E-mail: tfdf@pacbell.net

