Economy Heading for a Systemic Collapse into Hyperinflationary Great Depression

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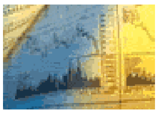
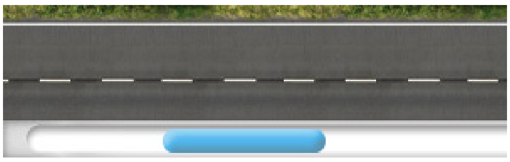
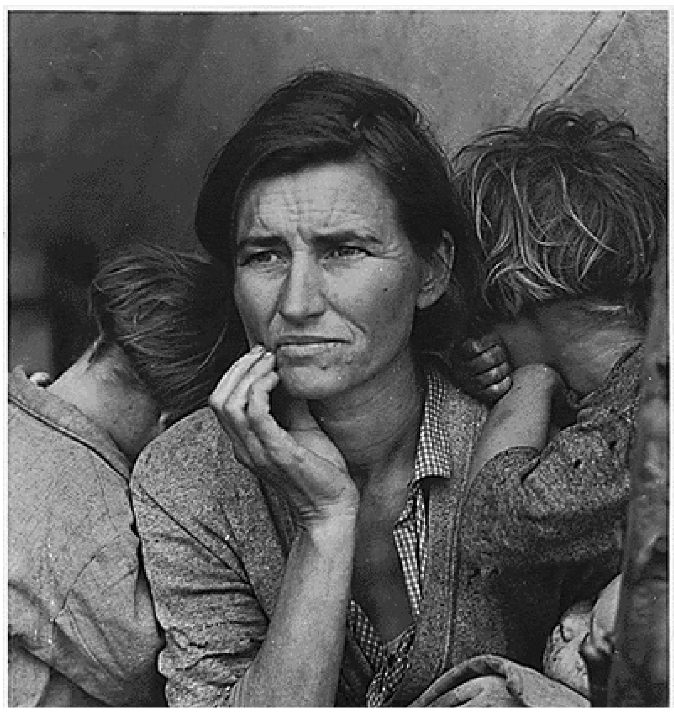
By: The_Energy_Report


Economics

When Fed Chairman Ben Bernanke admits to seeing an "unusually uncertain" economy ahead, it's pretty terrifying to imagine what he's really thinking. What John Williams envisions—and he's by no means looking to the far horizon—is a systemic collapse, a hyperinflationary great depression and the cessation of normal commerce. Despite that bleak outlook, however, when the economist and editor of ShadowStats.com sat down for this exclusive Energy Report *interview, he also had some good news.*





The Energy Report: A few months back, John, you said, "if you strangle liquidity you always contract an economy and deliberately or not, liquidity is being strangled, resulting in sharp declines in consumer credit, commercial and industrial loans." Does this mean it would spur more economic growth if banks actually started lending?

John Williams: It sure wouldn't hurt. We're still seeing contractions in liquidity, and that's adjusted for inflation. In real terms, M3 money supply is down almost 8% year-over-year. It's the sharpest fall in the post -World War II era. It's not so much the depth of the decline in the liquidity or the duration, but the fact that the liquidity turns negative year-over-year that signals the economy turning down.

We had the signal in December of 2009 indicating intensification of the downturn, in this case, within six to nine months. We're in that timeframe now and see softening numbers. People are talking about a weaker economy. Even Mr. Bernanke has described the economy as "unusually uncertain" in terms of its outlook. Wording like that from the Fed is a pretty good indication that something's afoot.

TER: Why is M3 still contracting?

JW: Just as you noted, the banks are not lending. The money the Fed put into the system in terms of buying mortgage-backed securities from the banks and trying to help bank liquidity ended up back with the Fed as excess reserves. We have well over $1 trillion there; had the banks loaned that money in the normal stream of commerce, it would have added more than $10 trillion to the broad money supply, which otherwise is up around $14 trillion. That certainly would have had some inflationary impact if not in terms of actual business activity. You can't always get the economy to grow by pushing money into it. Sometimes it's like pushing on a string.

TER: And you say that a contracting money supply is a sure sign of trouble?

JW: When it contracts year-over-year adjusted for inflation, that's a signal for a downturn or an intensified downturn. It happens every time. Squeeze liquidity and business activity contracts.

On occasion, we've had recessions without a preceding downturn in the money supply. And sometimes, the money supply has turned positive but the economy has not followed—again, pushing on the string. Expanding money supply has led to upturns as well, so the Feds had to give it a try to stimulate the economy. But the one sure signal is the downturn. You don't get it often but it's very powerful when you do.

We're beginning to see the data break. Some unusual factors have been at work. I expect an accelerating pace of downturn in the next couple of months. The numbers will turn sharply worse. Consensus estimates are already moving in that direction and most everything will follow. Industrial production is still up but retail sales have been falling. Payroll numbers have been flat when you take out the effects of the census hiring. Those employment numbers will turn down in the next month or two, providing an important indicator of renewed economic contraction.

So we'll see how it develops, but we're at that turning point. It is happening as we speak. At the end of July, we got an estimate of the second quarter GDP, where the pace of annualized growth slowed to 2.4%. The early GDP estimates are very heavily guessed at, so most of the time you don't know if you're getting a positive or a negative number. You get a margin of error of plus or minus 3% around the early reporting. That happens also to be about average growth.

Nevertheless, on a quarter-to quarter-basis, I think we'll see GDP down again in the third quarter. With the bulk of the reported GDP in the first half due to inventory building, the stage for renewed contraction has been set. By then we'll find the consensus pretty much in the camp that we're in a double-dip recession. The popular press will describe it as a double dip, but we never had a recovery. Actually, this is just a very protracted, very deep downturn that has had a pattern of falling off a cliff, bottoming out, having a little bit of bump due to stimulus and then turning down again. Sort of shaped like the path of a novice skier going down a jump for the first time. Speeding sharply down the hill, he goes up in the air and starts spinning wildly as he tries to figure out which end is up with his skis. Then he takes a pretty bad tumble. We're beginning to spin in the air.

TER: But we've been in recession for three years now?

JW: The second leg that I'm talking about is the one now underway as we get to the middle of 2010. December 2007 is when this recession officially started, although I contend that it started earlier in 2007. At any rate, the economy plunged through 2008 and well into 2009. The numbers were pretty much bottom-bouncing during the second half of 2009. The auto deals and the homebuyer deals added a little spike to the growth pattern, but that growth was stolen from the future. It didn't create new demand.

Let me just clarify a bit. Recession, at least traditionally, was defined as two consecutive quarters of contracting real GDP growth adjusted for inflation. The National Bureau of Economic Research, the defining authority as to whether we're in a recession, will deny it, but at one time they used that general guideline as well. They've always used other numbers, too, such as employment and industrial production, trying to time the beginning or the end of a recession to a particular month. Significantly they did not call an end to this recession. They said it was too early to call, but I think they had a pretty good sense of what was going to happen. So what we're seeing now just looks like an ongoing deep recession. The next down leg is going to be particularly painful and I'm afraid particularly protracted.

TER: Can the governments pull any more stimulus levers yet this year?

JW: Oh, I think they'll try, but nothing much they can do will have anything other than short-term impact. If they write everyone a check, people go out and buy things. That would give the economy a quick boost but do nothing to change the underlying fundamentals or to correct the structural problems in this recession. Those are tied to the lack of robust growth in consumer income.

TER: So consumer income is a key factor.

JW: Absolutely. If you put in housing that's related to the consumer, that's three-quarters of the GDP. The average household is not staying ahead of inflation, and unless income grows faster than inflation, the economy won't grow faster than inflation—and that means that GDP is not growing. Income sustains consumption. When income grows, consumption grows. The only way to have sustainable long-term economic growth is to have healthy growth in income. You can buy some short-term economic growth, though, without growth in income, through debt expansion, which is what Greenspan tried.

Most of the growth we'd seen in the last decade prior to this downturn was due to debt expansion. The debt structures have pretty much been put through the wringer and consumers are not expanding credit, generally because it's not available to them. Absent debt expansion and/or significant growth in income, no way can the consumer expand personal consumption. You have to address employment, quality of jobs.

TER: You're suggesting that problems with the quality of jobs, if not the quantity, goes back to Greenspan—before the recession kicked in.

JW: Yes. A lot of high-paying jobs have been lost to offshore competition, to U.S. companies moving facilities offshore and to outsourcing offshore. That's been the primary driver of declining household income.

TER: We no longer really have the option of expanding the debt and it's doubtful that even short-term stimulus will have much impact. Looking at this next leg down against that backdrop, what projections would you make about unemployment, housing prices, GDP as we look through the end of 2010 and into '11?

JW: Unemployment will be a lot worse than most people expect. Housing will continue to suffer in terms of weak demand. But in this crazy, almost perverse circumstance, the renewed weakness to a large extent will help push us into higher inflation. Real estate tends to do better with higher inflation, but it's not going to be a happy circumstance for anyone.

The government is effectively bankrupt. Using GAAP accounting principles, the annual deficit is running in the range of $4 trillion to $5 trillion. That's beyond containment. The government can't cover it with taxes. They'd still be in deficit if they took 100% of personal income and corporate profits. They'd also still be in deficit if they cut every penny of government spending except for Social Security and Medicare. Washington lacks the will to slash its social programs severely, to change its approach to ever bigger government. The only option left going forward is for the government eventually to print the money for the obligations it cannot otherwise cover, which sets up a hyperinflation.

All of what I just described was already in place when the systemic solvency crisis broke. Before this crisis the government was effectively bankrupt. In response to the crisis, the government may have gone beyond what it had to do, but you err on the side of conservatism when you're trying to prevent a systemic collapse. That was a real risk. It still is. Irrespective of the politics of big government spending, quantitative easing, renewed bailing out of banks, whatever is involved, I'd argue that the government still will do whatever it takes to prevent a systemic collapse. That last series of actions had the effect of rapidly exploding the deficit. In just a year, we went from something under $500 billion in official reporting, on a cash basis as opposed to

GAAP basis, to something close to $1.5 trillion.

TER: How big will that deficit grow in this second painful and protracted period?

JW: I can't give you a hard number, but I can tell you this. The markets came into this year on consensus projections that we'd have positive economic growth. Forecasts for the federal deficit, treasury funding, banking system solvency, etc. all were based on assumptions of recovery, of positive growth. Those assumptions presumably still underlie what I consider to be an irrational stock market.

But those projections and assumptions were wrong. We're going to have negative growth. The downturn will intensify. We're not in recovery. We have states on the brink of bankruptcy. The federal government isn't going to let California or New York or Illinois collapse. Those are threats to the systemic survival. They're also going to spend a lot more to support people on unemployment. Again, putting aside election year politics and such, the banking industry will need further bailout as solvency issues come to a head again. The federal deficit is going to balloon. It's going to blow up much worse than any formulas would give you, and Treasury funding needs will explode.

TER: Clearly you see us spiraling out of control.

JW: We've been talking about an economic recession, but we are headed for something far worse. I define a depression as a 10% peak-to-trough contraction in the economy. In terms of the broad economy, we're not down 10% in GDP yet. So while we're not formally in depression, we're certainly seeing it in a number of indicators and I think we'll be in a depression, with GDP down 10%, in the near future.

A contraction greater than 25% peak-to-trough puts you in a great depression. That is what I envision, but we'll be taken there by hyperinflation and a resultant cessation of normal commerce.

TER: Hyperinflation means different things to different people. How do you define it?

JW: My definition has been and will remain very simple. When the largest-denomination note in circulation—the $100 bill in the case of the U.S. dollar—has the same value as toilet paper, you have a hyperinflation. You saw that in the Weimar Republic. People papered their walls with money.

TER: I think you've said that the only reason that Zimbabwe's economy survived is because they started using dollars as black market currency.

JW: But you don't have anything like that in the United States as a backup. We're going to have a much rougher time in the U.S., of all places, than they had in Zimbabwe. Zimbabwe was able to function because people could exchange the local currency into dollars, and then buy things with the dollars, so the economy continued to function. Without some kind of a backup system, as the currency becomes worthless you'll see disruptions to key supply chains. When people don't have food, you end up in very dangerous circumstances.

TER: Do you see any real potential for precious metals or another currency as a backup?

JW: Well, yes. I think they will become a backup fairly quickly, but we don't have any widely developed black market for another currency at this point because the dollar remains the world's reserve currency. All sorts of things may develop that we don't anticipate. What will be used to cover for the dollar? Gold and silver? The precious metals are limited in supply and not widely held by the population in general. Hard currency from Canada or Australia? That wouldn't be in wide circulation, at least not early on. I think a barter system is where it will go until the currency system is stabilized, but the currency system can't stabilize until the government's fiscal house is in order.

There's no sense in setting up a currency on a gold standard if you can't live within your means, because you'd just end up going through successive devaluations against gold. So whatever's done to set up a new currency system will have to be in general conjunction with the overhaul of the government's fiscal condition. But in the interim, something of a barter system would evolve. Even that, though, is something that may take six months to get stabilized.

TER: It's hard to imagine.

JW: In the Weimar Republic, you could go into a fine restaurant one evening and enjoy its most expensive bottle of wine with a nice dinner. You'd probably negotiate the price before you sat down, because the price would be higher by the time you finished dinner. By the next morning the empty wine bottle would be worth more as scrap glass than it had been worth as an expensive bottle of wine the night before. That's how rapidly things change in a hyperinflation.

But we have a circumstance that did not exist in the Weimar Republic. Our society is heavily dependent on electronic cash. Say you have a credit card with a $10,000 limit. In hyperinflation, that $10,000 might be enough to buy you a loaf of bread.

TER: There's not even enough physical cash running around anywhere in the United States that actually represents what goes back and forth electronically. If you can't use your debit card, how do you pay for your coffee at Starbucks? And how will companies and banks adjust?

JW: You're not going to have electronic payments that are in-barter equivalent that I can foresee. That would be a fairly sophisticated system and the needs are going to be immediate. When hyperinflation starts to break, it can unfold in a matter of weeks, months. You'll need to be able to handle things rapidly. Frankly I think the system will tend to break down. It's not a happy circumstance. How will a small company get its goods to people? There might be blackouts. Who's going to get the fuel to the power plants?

TER: And to the gas stations for the cars for people who still have jobs?

JW: Yup. It will get very difficult. Society won't run as we're used to it. People will find a way, but it's going to take a little while for that to stabilize.

In an electronic society it's going to take some creative thinking by businesses. I'm sure some people will figure out some ways to accommodate these changes, but it's going to be a painful, costly process that won't be conducive to normal revenue flows—at least not as measured in inflation-adjusted dollars.

TER: I'm almost afraid to ask, but how will the stock markets fare when the system breaks down?

JW: Stocks generally tend to reflect inflation, since revenues and profits are in inflated dollars. If you look at stock prices adjusted for inflation, you can have a bear market as well as a bull market. But these are not going to be good economic times. So I think we're going to have a real bad stock market adjusted for inflation. I'd stay out of stocks in the U.S. With the U.S. markets in serious trouble, the rest of the world probably will see lower stock prices as well, but they're not going to have the hyperinflation.

TER: What will plunge us into this abyss? And when?

JW: I think the odds are extremely high that we'll see it break within the next year. I would put it six months to a year, outside. We're getting extraordinary protestations from other central banks about the U.S. finances, its solvency, risk of the dollar. Before the current crisis you never would have heard any central banker making such comments. As this breaks, it's going to be obvious that the U.S. is moving to debase its dollar. It'll have no option to do otherwise. I would fully expect some foreign holders looking to dump the Treasuries. With the dollar plunging, the Treasury won't be able to get the funding that it needs from a practical standpoint in the open markets.

The Fed will come in to salvage that situation, becoming the lender of last resort to the Treasury—literally monetizing the Treasury debt. The Fed might have a couple different ways to address the dollar situation, from raising interest rates to direct intervention, slapping on currency controls. I can't tell you exactly how it's going to go. But you'll have an environment that's effectively creating a perfect storm for the U.S. dollar. I hate to use the term but it's a good one.

Heavy dollar selling will be exceptionally inflationary. Oil prices will spike in response to the weakness in the dollar. Oil is a primary commodity that drives consumer inflation; that's how you can have inflation in a recession. The traditional wisdom is that strong demand against limited supply causes inflation, but you can also have inflation due to commodity price distortions, which is what we had back in '73 and what we've seen over the last year or so.

Most of the recent volatility in the CPI has been due to swings in oil prices, which have been directly tied to swings in the value of the U.S. dollar. About $7 trillion in liquid dollar assets that overhang the market outside the U.S. could be dumped overnight. We're going to be seeing a lot of pressure to accept that back in our system, and it will be very inflationary. The Fed's options will be limited, but again I'd expect them to try and maintain systemic solvency.

So what we end up with is a circumstance where the dollar is under heavy selling pressure. People will feel the squeeze on their inflation-adjusted income with much higher prices for gasoline and fuel oil. The route to the monetary inflation will take hold from the Fed's direct monetization of Treasury debt. As we discussed earlier, the mortgage-backed securities taken off the bank balance sheets have generally gone to excess reserves and are sitting with the Fed. That hasn't been inflationary so far because it hasn't gone into the money supply.

TER: How do we get through this, John?

JW: If there's no solution for the system—and I don't see one; I think it just has to run its course—there still is good news. We as individuals have ways of protecting ourselves, our families, our friends, our businesses—whatever is important to us. To do that we have to preserve the value of our wealth and assets in order to ride out the storm. As terrible as it will be, it will end. A time will come when things become self-righting and the people who have been able to survive will be able to do some extraordinary things.

TER: And what do you advocate in terms of individuals preserving wealth and assets?

JW: Hold some gold, silver, precious metals. I'm talking physical possession. Preferably coins because coins, sovereign coins, are recognized as such. They don't have liquidity issues. Having some assets outside the U.S., and certainly some assets outside the U.S. dollar, is a good thing. I like the Australian dollar, the Canadian dollar, the Swiss franc in particular. They won't suffer the same hyperinflation in Australia, Canada and Switzerland as we do in the U.S., so those currencies will tend to act as ways of preserving wealth. Over time real estate is a traditional store of wealth, but it's not portable and sometimes it's not liquid.

If I'm right about what's going to unfold, a significant shift in government is possible; suppose the government moved so far to the left where maybe private ownership of property was not allowed. Having a lot of assets in real estate under those circumstances might not be so good. I think generally real estate is a good bet but you also have to consider the risks. Use common sense. Think through different things that could happen.

Most importantly, build up a store of supplies, more than you would normally consume over a couple of months, particularly food and water, canned goods. Having those goods can save your life in a number of ways. You'd have food to eat, and if you have extra you can use it to barter. I met a guy who'd been through hyperinflation and found for purposes of the barter system those airline-size bottles of high-quality scotch proved quite valuable. Buy things that you would otherwise consume and rotate your inventory. Don't go out buying all sorts of things you'll never use. Keep what makes sense to you and your circumstances. Make sure you have things that are stable. Not too perishable.

I had a professor at Dartmouth who'd lived for a while in a hyperinflationary environment that devolved into a barter system. He told a story about how his father had traded his shirt for a can of sardines. He decided to eat the sardines, which was a mistake because they had gone bad. But nonetheless that can of sardines had taken on monetary value. So when you look to trade things you want to be careful what you're doing.

TER: How long does a hyperinflation environment typically last?

JW: I guess it depends on how comfortable people can be in the environment. It went on for a couple of years in Zimbabwe, but they were able to function. Here, in a system that can't function well with it, it's not going to last too long. You won't have a usable currency. It's likely a barter system would evolve, and if it became stable and functioned well, it could last for a while. People don't want to starve. If that's a real risk, they will take action to protect themselves. We may have rioting in the streets. The government might declare martial law. If people can live comfortably with hyperinflation it would tend to linger. The more difficult things are, the faster people will move to remedy it.

TER: Well on that note is there anything that we can do as voting citizens to turn this around? Or minimize the impact?

JW: If things break slowly enough that people can see what's coming and respond, tremendous change may result from what comes out of elections. Incumbents are going to have a rough time. The circumstance is open for the development of a major third party that could knock out either the Republicans or the Democrats as a second party. Over time, pocketbook issues tend to dominate elections. If things are going well, if people are prosperous, they ignore the corruption in political circles as being just part of the system. But when they're hurting, they turn out the bastards and look to put in some change. We sure need change. I can tell you that. It's not just one party. Both major parties have an equal share of guilt in what's unfolding. . .whichever one is in power keeps making it worse.

TER: Not very happy thoughts, John, but we appreciate your insights and look forward to talking with you again as we move through these trying times.

*Walter J. "John" Williams, is a Baby Boomer who has been a private consulting economist and a specialist in government economic reporting for more than 25 years, working with individuals and Fortune 500 companies alike. He received his AB in economics, ***** laude, from Dartmouth College in 1971, and earned his MBA from Dartmouth's Amos Tuck School of Business Administration in 1972, where he was named an Edward Tuck Scholar. John, whose early work prompted him to study economic reporting and interview key government officials involved in the process, also surveyed business economists for their thinking about the quality of government statistics. What he learned led to front page stories in the* New York Times *and* Investor's Business Daily*, considerable coverage in the broadcast media and a joint meeting with representatives of all the government's statistical agencies. Despite a number of changes to the system since those days, he says that government reporting has deteriorated sharply in the last decade or so. On the bright side, it keeps John and his economic consultancy, Shadow Government Statistics, in the limelight. His analyses and commentaries have been featured widely in the popular domestic and international media.*

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2) The following companies mentioned in the interview are sponsors of *The Energy Report:* None.
3) Greg Gordon: See Morgan Stanley disclosure that follows.*

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Shelby Moore
05 Aug 10, 22:56

Greatest opportunity of our lifetime
Excellent article, John Williams speaks with great clarity given his deep experience with the hard data.

This hyper-inflation and shift to new currency system, is going to present a great opportunity to become extremely wealthy, but unfortunately mostly only for the elite:

http://www.marketoracle.co.uk/Article20327.html

Thank you.

Systemic Collapse
07 Aug 10, 05:50

Systemic Collapse
As the enclosed resources will prove, it's just a matter of timing and details, not of outcomes.

-wrb

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http://news.kontentkonsult.com/2009/02/readers-resources-on-systemic-collapse.html

28 February 2009

A reader's resources on systemic collapse

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My definition of an expert in any field is a person who knows enough about

what's really going on to be scared.

- P. J. Plauger, Computer Language, March 1983

Economic Depression, Civil Unrest and the breakdown of order in America.

The resources I've enclosed below are by credible people - professionals,

educators, journalists, policy makers, businessmen and nationally and

internationally recognized experts.

For example, Joseph M. Miller retired as a board member of the Chicago

Mercantile Exchange. One of his associates is a physicist who worked for

Control Data Corporation. The other, Marion Butler, has a background as a

CFO. Niall Ferguson holds a Chair in the history department at Harvard.

There's an article by Israeli historian Martin van Creveld. Dr. Krassimir

Petrov is from Prince Sultan University, Saudi Arabia. Pranab Bardhan is a

professor of economics at Berkley. David Rosenberg is Merril Lynch's North

American Economist. Carmen M. Reinhart is a professor of economics at the

University of Maryland. Phil Howison is from Victoria University, Wellington,

New Zealand. Professor Michael T. Klare is from Hampshire College.