As painful as this recession has been, the hardship would be much worse if it were accompanied by inflation. For now, at least, deflationary pressures prevail, although most economists forecast that consumers will face higher inflation-driven prices – even if they are not sure when.

Some fear much worse, however, and predict hyperinflation. John Williams makes that case eloquently and forcefully. Williams, who runs Shadow Government Statistics, is best known for exposing inaccuracies in the Consumer Price Index (CPI), which he said has been systematically understated through “gimmicking” by the government since the Clinton administration.

Williams says we are now on the road to Zimbabwe, which has suffered hyperinflation for nearly a decade and was forced to abandon its currency earlier this year in favor of the US dollar.

Those dollars will be similarly worthless, according to Williams, at some point in the next five years. He predicts 20% inflation in the next six months and says the risks of hyperinflation are “particularly heavy in the early part of 2010.”

Williams defines hyperinflation precisely: it is in effect when the largest denomination of currency (in our case, the $100 bill) is worth less than a sheet of toilet paper. Zimbabweans routinely use their paper currency for this purpose – it’s now cheaper than the real thing.

Zimbabwe is not the only country to have experienced hyperinflation. It happened in Germany’s Weimar Republic in the 1920s, Hungary after World War II, and in Yugoslavia in the early 1990s.

Williams’ first issued hyperinflation warnings in 2006 and he has since updated his forecast though a series of Hyperinflation Special Reports, available to subscribers to his service. The basic forecast has not changed, he says, but the forces driving us toward hyperinflation are intensifying.

The crux of the crisis

Hyperinflation is imminent, says Williams, for one basic reason: Government debt cannot be financed in the long-term, as the unfunded liabilities from entitlement programs (Social Security, Medicare, and Medicaid) will overwhelm our ability to service
our debt. Williams estimates the size of these liabilities at over $65 trillion as of the end of fiscal year 2008 (about five times that of our GDP), and expects them to grow to $75 trillion at the end of fiscal 2009. His 2008 estimates are consistent with those calculated by Jeff Gundlach of TCW but exceed those of PIMCO’s Bill Gross (who puts the number at $40 trillion).

Those liabilities do not include the costs of proposed programs, such as health care reforms and bailouts of foreclosed homeowners. “With no full funding available for any new programs,” says Williams, “the government again is showing its willingness to spend whatever money it has to create.”

The prescription drug program enacted in 2004 under the Bush administration added $8 trillion in unfunded liabilities – more than the size of the government’s debt burden at the time. Recent government decisions, Williams says, to partially or fully nationalize banks, automakers, and mortgage companies “are not going to save money. It will cost us a lot more and add to those unfunded liabilities.”

Financing these debts will force interest rates higher in order to attract lenders. Those lenders – most importantly the Chinese – will diversify their borrowing and investing activity, and become far less dependent on the US Treasury debt than they are currently, forcing interest rates to even higher levels. That process is already unfolding, as evidenced by recent warnings from Chinese central bankers against the dangers of a falling dollar. “Dollar dumping” will force a flight to safety outside the US by foreign countries, who have purchased approximately 80% of new Treasury issuance over the last five years.

Williams calls this debt-driven downward spiral “dollar debasement” – “the U.S. government’s willingness to spend whatever money they have to create in order to keep the financial system from imploding.” The Federal Reserve will be forced to monetize its debt, effectively printing more money to pay the interest on its increasingly out-of-control debt.

I asked Williams why the US dollar will suffer so heavily vis-à-vis other currencies. After all, the US economy is far bigger than that of any other country and as such should be especially resilient. But Williams says that the Europeans have been more honest and realistic about their economic conditions, and that no other country has “so deliberately and excessively debased its currency through fiscal and monetary policies.” Only the United Kingdom has unfunded liability exposure (as a percentage of GDP) that rivals the US’s.

Some elements of Williams’ forecast are already unfolding. He says the weak dollar has been key to the recent rebound in oil prices, which is providing the “roots for a pickup in consumer prices.” Despite the ongoing downturn, inflation will increase in July and August because of the weak dollar, he says.
Debt monetization is already occurring, as the Fed has been buying longer-term Treasury bonds. As the demand for Treasury debt dries up, Williams says the Fed can either allow long term rates to spike or it can step in and buy securities to keep rates down and markets stable. It has chosen the latter – and that is monetization.

The economy has been in a recession since late-2006, according to Williams, and things will get worse. Once you adjust for the gimmicking of CPI numbers by the government, we are in an inflationary recession that is at least half-way toward Williams’ definition of a depression. He does not rule out further “bounces and dips” in economic activity, but the ultimate destination will be a second Great Depression – which, thanks to hyperinflation, will be more disruptive than the original.

Government policies like free trade programs have moved technology and manufacturing jobs off-shore, crippling the US economic base. Williams says this has driven down workers’ inflation-adjusted wages and has reduced personal consumption, the largest component of GDP. Using the government’s numbers, the inflation-adjusted weekly earnings for workers has not regained its peak set in the mid-1970s. Back then, dual wage-earning families were rare; now they are commonplace, as households seek ways to make ends meet.

GDP growth was artificially inflated through consumer debt expansion and savings liquidation over the last 25 years, but that source of growth is gone. Without robust consumer spending, the economy is in a structural decline, and Williams says it will take a “decade or two” to recover.

**Finding a solution**

There is no way out. For example, I asked Williams whether we could grow our way to solvency, through prudent and efficient stimulus and budget spending. He says this is an “absolute impossibility.” The debt burden is too great. Even if tax rates were increased to 100% of corporate and personal income, Williams says the resulting revenue would be insufficient to cover the deficit.

Slashing Social Security and Medicare spending might be an option, Williams says, but instead of doing this, the government is looking to do the opposite. “The cuts needed are so severe that they would elicit a radical political reaction,” he says. “It’s not just a matter of advancing the retirement age from 65 to 75.”

Healthcare reform to curtail malpractice claims is similarly impossible, since the powerful trial lawyers’ lobby opposes such efforts, according to Williams.
Portfolios for hyperinflation

If you accept Williams’ economic forecast, then you can follow his investment advice, which is to “protect yourself from the debasement of your currency” and hold gold and possibly some silver. Real estate is a reasonable hedge in hyperinflation, but lacks the portability of gold. Equities will suffer – Williams forecasts a 90% market decline once hyperinflation sets in. As you would expect, Williams recommends diversifying away from dollar-based assets.

You can refuse to believe and dismiss Williams’ forecasts. Williams may be wrong – I certainly hope he is – but every advisor must have a response to his claims. If you don’t, then you should follow his investment advice.

Williams may have miscalculated on several fronts. Political pressure may mount to reform the entitlement programs as we are pushed closer to the brink of that crisis. Reforms, like indexing Social Security increases to the cost of benefits instead of wages, are possible. Tax increases are a certainty. And you cannot discount the possibility of extreme – and unforeseeable – measures the government would take to avert this disaster, which could be virtually anything short of declaring bankruptcy.

We like to hear from our readers – what is your response to the threat of hyperinflation? Send your comments to feedback@advisorperspectives.com

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