Chapter 1

As Good as Gold?

Nature's first green is gold,
Her hardest hue to hold.
Her early leaf's a flower;
But only so an hour.
Then leaf subsides to leaf.
So Eden sank to grief,
So dawn goes down to day.
Nothing gold can stay.
—*Robert Frost*

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On a hot summer night, August 15, 1971, the Who played to a sold-out crowd in Bloomington, Minnesota. Their music spoke to a generation that sought a journey down a different path from their parents . . . a generation that had grown hostile with rules and authority . . . a generation eager to put aside the old ways and forge a new path . . . create a new world, a better world. They promised themselves they wouldn't get trapped in the sins of the past; they vowed that this time things would be different.

On that same night, a president addressed the nation in a similar vein. It is unclear if Richard Milhous Nixon knew who "the Who" was, but his message for the country was much the same. He, too, wanted a new

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direction. Toss out old rules that were holding back an economy, in favor of building a *New Prosperity*—one that would move America forward while "protecting the position of the American dollar as the pillar of monetary stability around the world." He addressed the nation . . .

> I have directed Secretary Connally to suspend temporarily the convertibility of the American dollar except in amounts and conditions determined to be in the interest of monetary stability and in the best interests of the United States.
>
> Now, what is this action—which is very technical—what does it mean to you?
>
> Let me lay to rest the bugaboo of what is called devaluation.
>
> If you want to buy a foreign car or take a trip abroad, market conditions may cause your dollar to buy slightly less. But if you are among the overwhelming majority of Americans who buy American-made products in America, your dollar will be worth just as much tomorrow as it is today.
>
> The effect of this action, in other words, will be to stabilize the dollar.[1]

If you needed any more proof that Dick was not only a horrible president but that he also knew next to nothing about economics, that should close the case. According to Mr. Nixon, Americans need only to worry about a crumbling currency while on vacation—if they could still afford to take one. He either was lying or simply just unaware that when a central bank can print money by decree and is not fettered by the strictures of a gold standard, not only does it lower the exchange rate of the dollar against foreign currencies, but it also lowers its exchange rate against everything you need to purchase within the United States. But even more damaging, the ability to increase the money supply at will has also been the progenitor of every bubble that was ever created.

Nixon's plan for "New Prosperity" was decided in haste over a weekend summit at Camp David. With this speech, Nixon ended the agreement of Bretton Woods that placed a value internationally on the U.S. dollar's ability to be exchanged for gold at a fixed amount—in this case, $35 an ounce. It is clear from tapes later obtained from that weekend that Nixon wished to remove any impediment that would keep

the Federal Reserve from "printing like crazy." Nixon was up for reelection. The recent influx of soldiers returning home from Vietnam was creating a spike in the unemployment rate, a spike that he wasn't sure the market could work out in enough time. Paranoia was setting in. . . .

With this speech, the U.S. dollar was no longer collateralized by gold; it no longer had a precious metal backing. The U.S. dollar was now a fiat currency—a currency established by government decree. Although Nixon loathed economics and monetary policy, it wasn't lost on him that a fiat currency gives a government carte blanche to spend without taxing. Governments can incur tremendous amounts of debt and can always make good on their principal and interest payments because they can print money. Default comes through inflation instead. Default via inflation is worse than actual default.

Inflation is a hidden tax that disproportionately affects those least able to pay it: the middle class and the poor. Inflation provides a disincentive to savers; it favors borrowers, as borrowers get to borrow in today's dollars and pay back in tomorrow's cheaper dollars. Inflation destroys the standard of living of the elderly and those who rely on a fixed income. Inflation breeds resentment among economic classes and contributes to political unrest and disunity. A nation that resorts to the use of fiat money has doomed itself to economic hardship and political disunity.[2]

On that fateful night, Nixon eliminated the final link the dollar had to gold. It was Franklin Delano Roosevelt (FDR) in 1933, in a move that accelerated bank failures during the depression, who originally took the dollar off the gold standard. We will address the Great Depression in more detail in the next chapter; however, it is clear from centuries of history that when a nation moves off of specie (metal), its population loses confidence. As Ronald Reagan once said, "A great nation that moves off gold doesn't stay a great nation for long."[3]

It is no surprise that the 1970s were a tumultuous period in American history. Much like today, it was a period of stagflation—rising prices and zero economic growth. Your income went down and the cost of everything you purchased went up. Since 1973 the American paycheck has been decreasing in real dollars. Between 1971 and 1982, the cost of living increased from 3 percent to 15 percent, yet the unemployment rate soared from below 6 percent to just under 11 percent. Taking into account Nixon's decision to go off gold in

1971, it's no coincidence that the cost of living started to increase from the 3 percent level to the double digits later that decade.

Let's put in it terms even "Tricky Dick" could understand. Take Pat Nixon's "Republican cloth coat." If that coat cost $18 in 1971, it would cost $100 today—good thing Pat didn't want the mink! In 1971 the Nixons could buy a can of dog food for their dog Checkers for $0.22; that same can costs $1.25 today. How about the cost of bugging the White House or a Watergate break-in in today's dollars—yikes! Nixon would have a hard time making his famous claim "I am not a crook" because on that day in August 1971, Richard Nixon robbed from every American alive and from future generations—he stole a precious-metal-backed currency from a nation and robbed its people of their purchasing power.

One has to wonder if a young Tim Geithner was watching on the night Nixon addressed the nation. Sitting in front of his Philips color TV, with his Little Joe cowboy hat and holster on, geared up to watch *Bonanza*, his favorite show. Ah, the disappointment that little Timmy must have felt knowing it would take another week for him to enjoy the exploits and adventures of the Cartwright family on Ponderosa ranch. I can't imagine that little Timmy realized then what a favor was bestowed on him that night. His future job just got a whole lot easier. He would never have to ponder the question of "who is going to buy all this debt I'm selling at these lousy rates?"[4]

Thanks to Nixon, Tim just has to tell Ben to keep the printing press going.

The Great American Money Machine

Today our counterfeiter–in-chief, Ben Bernanke, holds the lofty position as the veritable "Master of the Universe." He sits at the helm of the ultimate printing press and controls the reins of the Great American Money Machine—also known as the Federal Reserve. Ben holds the ultimate power of the known universe: the power to create the world's reserve currency, the U.S. dollar, out of thin air. I often wonder how many people in the country even know who Ben is or what the Federal Reserve does. One could conjure a "man on the street"–style inquiry

affirming who has more name recognition: Ben Bernanke or Kim Kardashian? Unfortunately, while some were busy "keeping up with the Kardashians," the "geniuses" at the Federal Reserve have been wreaking havoc with our economy, destroying the purchasing power of the dollar and savaging the middle class. Now you could counter that Kim seduced her audience into watching an entire season consumed by her sham marriage to Kris Humphries. But since I have just told you everything I know about Kim Kardashian, for the purposes of this book, let's focus on Bernanke, the Federal Reserve, and how they have helped create the biggest and most deadly bubble in the history of the planet.

To do this, our story takes us back to the year 1907, and like all great government power grabs—this one begins with panic. . . .

The panic of 1907 was a financial crisis that almost crippled the American economy. Major New York banks were on the verge of bankruptcy; at the time, there was no mechanism to provide timely liquidity. J. P. Morgan, a prominent banker of his day, stepped in personally and took charge, resolving the crisis. Similar to banks today, the banks in 1907 operated on the assumption that people don't move in unison in demand of their deposits on the same day. The "run on the bank" that ensued after the 1907 crisis gave the public anxiety and led the politicians to create a mechanism for a "lender of last resort."

The United States had forayed in central banking over its, at that time, more than 100-year history. Past attempts at central banking had failed miserably; they proved the central bank corrupt and left a population disillusioned and disgusted. But those who embraced an illusory concept of a "new paradigm" certainly saw a "new time" in America. One can speculate that some in the political establishment of the day thought that this time things were different—that different times called for this kind of authority and that these "new times" would result in a different outcome.

It's important to explore the political climate in place in 1907 and the years leading up to the creation of the Federal Reserve. Teddy Roosevelt ran as a Republican, but he was really a Progressive. I love the term *Progressive* because it is so unapologetically misleading. The term *Progressive* makes you think "progress," and who doesn't want progress? Progress is great. If you look the word *progress* up in the dictionary, it's defined as moving toward a goal, to advance. I love progress and

advancement! Progressives must have been great . . . WRONG! These Progressives aren't interested in my progress or your progress; they aren't interested in the advancement of the individual. Progressives want the government to progress; they want the government to advance. They see progress when the government takes power from the individual and transfers it to government. So when I eat right and exercise, I think, "I'm making progress toward my goal of staying healthy and getting in shape—great!" But it's only progress to a Progressive when Michelle Obama tells me what to eat and how much to exercise. I think you get my point.

The Federal Reserve was created during a time when all kinds of "progress" was being made, so you would have to assume a major government power grab was in play, and believe me . . . this power grab didn't disappoint!

There are hundreds of books written about the creation of the Federal Reserve, and this book doesn't pretend to be one of them. I do not plan at this time to labor through the political posturing and the various iterations that went into the creation of the Federal Reserve. It is noteworthy that unlike Nixon's ending the gold standard, the architects of the Federal Reserve took a lot longer than a weekend. Like Rome, the Federal Reserve wasn't built in a day. In retrospect, maybe too long—by the time the Federal Reserve opened its doors on December 23, 1913, it was clear that its original purpose, to prevent a run on the bank, was obfuscated.

In his book *The Creature from Jekyll Island*, author G. Edward Griffin points out that the Federal Reserve is neither federal nor is it a reserve—in fact, it is not even a bank.[5] But the deception just starts there. It is, in fact, a private company whose directors, or governors, are made by public appointment. It was deceptively designed to appear separate from the federal government, to delude the *masses* into believing that it was making sound monetary decisions independent of political pressures. It is a centrally planned organization that directly influences every aspect of the American economy. It holds a monopoly on dollar printing and runs a cartel on short-term interest rates. It is an organization like no other. It is the money machine of the federal government that enables the state to borrow far in excess of the private sector's savings.

Just think, as recently as a decade ago Ben Bernanke was pontificating economic theory with a bunch of college students at Princeton

University. Then, we can imagine, one day while Ben was debating the Keynesian theory of money demand in the faculty lounge with Paul Krugman, the "red phone" rang. Ben was selected to join the group of "superheroes" tasked with managing the economies of the world at the Halls of Justice, also known as the Federal Reserve. A mere three years later, Ben ducked into a phone booth with Alan Greenspan. When Ben later emerged, he donned the cape and held the title of "Master of the Universe."

Now if you are a fan of comic strips, and even if you're not, you know that all superheroes have superpowers—Ben's powers at the Fed are no exception. The Federal Reserve has three powers at its disposal to manipulate the supply of money.

The first is the reserve requirement, or the amount of money depository institutions must hold on hand against specified liabilities. And by liabilities I mean your money on deposit at the bank. The Fed dictates how much of a depositor's money needs to sit on hand with them for safe-keeping. We will go just a bit more into this when we consider how money is created and discuss fractional reserve banking later in this chapter. For now, just consider that an easing of the reserve requirement theoretically gives banks the leeway to increase their lending; in turn, increasing the requirement would have the opposite effect.

Next is their cartel on the discount rate. The discount rate is the interest rate charged to commercial banks and other depository institutions on loans they receive from their regional Federal Reserve Bank's lending facility, also known as the discount window. This gives the Fed complete control over the short end of the yield curve. When the discount rate is lower than the prevailing market rate and the yield curve is high, it provides a huge incentive for banks to borrow from the Federal Reserve and loan out at higher rates. Today's rate stands at zero percent, and Ben has promised it will stand for a very long time.

Finally, we have Bernanke's favorite superpower—drum roll please—open market operations (OMOs). Through OMOs the Fed usually purchases government securities from banks. However, as the credit crisis has clearly illustrated, if the Fed desires, it can also buy an entire array of toxic assets that are worthless.

Now, like Superman had kryptonite, Ben also has something that he believes weaken his powers—congressional oversight. One would

assume that in giving a small group of unelected pseudo-bureaucrats so much power, the people who appointed them would need to know exactly what they were doing. Well, you would assume wrong. Remember, the Federal Reserve is a private company. So you don't expect that Pepsi is going to open up meetings to the public where they discuss changes to their secret formula. The difference is that if Pepsi were ever to water down their product, the consumer would have the right to switch to Coke. When the Fed waters down its product (money), few people are afforded the discretion to make other monetary choices.

Therefore, the Fed enjoys not only a monopoly on money but also the latitude to hold many of its meetings in the "cone of silence." In other words, nobody really knows what exactly these clowns are up to. Now, we can give Ben a little bit of credit—his predecessor, Alan Greenspan, seemed to speak in tongues. The media coined the term *Fed Speak* to describe Greenspan's cryptic communique. It would take a panel of economists and financial types to decipher what Greenspan was saying. So, in this way, Ben is a veritable man of the people—even going as far as an appearance on *60 Minutes*. Mr. Bernanke believes it should be Glasnost at the Fed. However, when your stock-in-trade is counterfeiting money, it isn't really a good idea to promulgate what you're up to.

Putting aside Bernanke's plain-spoken and more accessible posture, he still is obstinate about keeping most meetings and dealings with other central banks secret. There is currently a movement in Congress to audit the Fed, which Bernanke is vehemently opposed to. Apparently, if we knew what he was doing, this would weaken his superpowers and jeopardize the power he holds to control the economy. Maybe Ben should realize that's the point.

"Dad, Where Does Money Come From?"

As a father of two young children, I grow anxious for the day my son will ask the question every parent anticipates: "Dad, how is money created?" My answer will go something like this: "Son, when the U.S. Treasury and the Federal Reserve really love each other, they create

money." . . . Judging by the amount of money being created today, it is clear that Ben and Tim have a Brangelina kind of love.

The Federal Reserve doesn't actually need the Treasury; it can create money all on its own—but money is usually created at an administration's prompting. Tim and Ben, like so many high-profile couples these days, make use of a surrogate to create money. The Federal Reserve introduces new money into the system by increasing its balance sheet through the purchase of financial assets and by lending money to banks. Then, something amazing happens—the money multiplies. This money magic is brought to you by the fractional reserve banking system and this is how it works:

Let's assume a very simple banking system: we have one bank (Bank A) and a central bank (the Federal Reserve).

You make a deposit of $100 in a checking account, and the Federal Reserve requires Bank A to deposit a fraction of it, let's say $10 of the $100, with it for safe-keeping. This is the Fed's Reserve Requirement, and they reserve the right to increase or decrease the percentage held in reserve.

Bank A now has $90 burning a hole in its pocket, ready to loan. Now, technically, this is your money, on loan with Bank A, and you have the right to demand this deposit at any time, but Bank A isn't going to spend a lot of time worrying about that. After all, it just deposited $10 with the Fed, so it's good—right?

Well, not much time has to pass before another person comes along and borrows the $90 from Bank A. Now, Bank A pays you interest on your deposit at today's rate (which is likely next to nothing) but charges this new person, let's call him Bob, 5 percent for your $90. This may not seem fair, but remember, with the deposit at Bank A, your money is "safe"; it's not just tucked under your mattress—it's now safely deposited in a vault at the bank. Well, actually a fraction of it is deposited, the rest just walked out the door with Bob, but I'm sure he's a great guy.

Now, Bob has all sorts of plans for your $90, but while these plans coalesce he decides to deposit the $90 in Bank A, so it stays "safe." Bank A considers this as an additional $90 deposit and it deposits $9 with the Fed and has $81 to lend out. It then loans that $81 to Mary, and this continues. Of course, you can forget most of what you just read because: *U.S. regulatory changes implemented during the early 1990s effectively removed*

the requirement for banks to hold reserves. They must hold reserves for demand deposits, but through the process known as "sweeping" they are able to get around this requirement by moving that money into time deposits. Therefore, in effect, banks can expand the money supply far beyond the reserve requirement as long as they have the required regulatory capital to do so.

As I said before, this is called *fractional reserve banking*, and it allows money to multiply; this calculation is conveniently called the *money multiplier*. Now, all this is great until Bob and Mary buy houses that they really can't afford and default on their loans, and you get antsy and want your $100 back. This is where the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve come in; they stand ready to bail out the bad decisions that Bank A made with your money.

Over the past few years, the Federal Reserve has been utilizing its OMOs to push money into the economy in a system called *quantitative easing* (QE). QE is a "last resort" for central banks when interest rates are already at zero percent. Simply put, the Fed buys Treasury notes and bonds from banks, giving banks money. The hope is that the banks will use the proceeds to lend more money—often to the government—and increase the amount of money in circulation.

We suffered through multiple rounds of it, and the only thing it did was boost inflation to 3.9 percent (as the government miscalculates it) and boost the money supply of M2—a measure that includes outstanding currency and money in checking and savings accounts—to a 29 percent annualized rate.

That is, while the U.S. economy is still in the doldrums, the amount of money in the system ballooned. If you don't feel the effect of that money, that's because it hasn't made it to your pocket; you'll see where it ended up in a minute.

So what went wrong? Why didn't QE fix everything?

Well, the Fed was right—if you give banks money, they will lend it out. The problem is, instead of lending it to you or me, they happily lent most of it to Uncle Sam. Yep, the banks sold Treasury notes to the Fed and then used the proceeds to buy more Treasury notes. This obviously hasn't helped the economy, but it has enabled the government to sell debt at low rates and run an annual budget deficit in the trillions.

As I write, the Fed through its OMOs will be moving toward a run rate of funding about 75 percent of our annual deficit. We have indeed

become a banana republic that now monetizes most of its new debt. While most global central banks have adopted the specious idea that prosperity comes from a depreciating currency, the Bernanke Fed is leading the way toward ensuring that the U.S. dollar loses its status as the reserve currency of the world. The United States has left interest at near zero percent for almost four years and has the central bank on record saying that inflation is far below their comfort zone. Therefore, because Bernanke is doing everything in his power to step up the dilution of the dollar, the rest of the world may soon reconsider their decision to continue to park their savings in dollar-denominated assets.

Since the endless QEs have failed to get this economy moving, Ben has created a new dance move he calls *Operation Twist*. This is Ben's attempt to manipulate the long end and flatten the yield curve. With long-term interest rates at an all-time low, this new move seems a little like kissing your sister—in other words, pointless. Apparently, the individuals at the Fed aren't satisfied with all the destruction they have already caused by printing money, keeping reserves low and keeping the discount rate at zero. Ben and his "Merry Men" of manipulators seem not to be content with their cartel on the short end of the curve; these legalized counterfeiters are determined to do the maximum intervention possible in order to not allow this economy to liquidate and experience a real recovery. Imagine that! I realize it's terribly out of fashion, but the only way this economy will achieve a viable recovery is if we allow markets to work.

There is no doubt that Bernanke has been remarkably successful in destroying the purchasing power of the dollar and in his quest to increase the rate of inflation. However, the truth is that there is no credible exit strategy for the Fed. There is only the prospect of suffering through either a deflationary depression or hyperinflation. Such will be the consequences of not appropriately dealing with our problems of debt, asset bubbles, and inflation in recent history.

The Implications of a Fiat Currency

Let's review. First, the U.S. dollar is no longer in any way, shape, or form linked to gold. Now, you might say, "Pento, enough with your obsession with gold—who cares?"

My response is: First, I don't have an obsession with gold. But I do want to make a few points about why it matters—please bear with me.

Take out a dollar from your pocket and think to yourself—what is this worth? The answer is that it's worth what it will buy you. So if I take this dollar and go to the store and buy a cup of coffee—which, by the way, if you know of a store that sells a cup of coffee for a dollar, I would like to know where that is; I pay a lot more than that. But I digress; if you buy a cup of coffee for a dollar, then that's the value of the dollar—a cup of coffee. Now, let's imagine that next week that same cup of coffee costs $10—now what is the value of the dollar? You are less certain because you are starting to lose confidence in your dollar's value. The next week the coffee is $100—wow! Now you use all the dollars you have to stockpile coffee—you cling to a hard asset, and it dawns on you what a fiat currency really is. That dollar was worth something only because you believed it to be worth something.

The dollar is a fiat currency—it has no real value beyond your confidence in it. No one worked to produce that dollar; no one put their hands in the dirt and got sweat on their brow to deliver that dollar to you. That dollar was created by the Federal Reserve and the fractional reserve private banking system out of thin air. And your confidence in it is your confidence in them.

To paraphrase Milton Friedman, there are no angels in government and there are no angels at the Federal Reserve. They are men and women who have intellectual limitations and are subject to the same pressures as all humans. Earlier, I spoke in jest of Ben Bernanke as a superhero—in case this point needs clarification . . . he's not. As far as I know, and maybe Donald Trump could verify this, Ben Bernanke was born on planet Earth—he is a human being. Prior to joining the Fed, he was a professor at Princeton University; I mention this only to inform you that he wasn't beamed down to Earth by some great deity who bequeathed him with all the answers to the world's monetary questions. Yet he gives the pretense that he was. But ask yourself: is Ben Bernanke smarter than the institution that brought prosperity and stability to the Byzantine Empire for over a thousand years? Can he outintellectualize the standard that engendered the Industrial Revolution—the most prosperous time in this nation's history? Is Ben Bernanke as good as gold? He's not. He is just one man who has been erroneously granted too much power.

The chairman of the Federal Reserve is not superhuman and, as such, should not be bestowed with such supremacy over money. You see, even though Superman is a fictional character, his creators had the foresight to have him originate from another planet. Why? Because they know that any human who has x-ray vision would spend his days undressing Lois Lane, and any human that could leap tall buildings would be a starter with the New York Knicks, not making minimum wage as a beat reporter at a second-rate newspaper. Superman is from Krypton because his creators knew that if humans here on Earth were given such power they would find it impossible to exercise such restraint; humans are vulnerable to their own mortal imperfections. Federal Reserve chairmen are vulnerable to facilitating reckless government spending and temerariously using their power in a misguided attempt to save the world.

Why a gold standard? The gold standard is the world's natural God-given money supply regulator; it has held the test of time. Gold is mined at about a 1 percent increase per annum in supply, so that would mean that gold would flow into the system and the money supply would grow at 1 percent—which is about consistent with U.S. population growth. Take into account a mild deflation resulting from productivity growth, and there you have it: stable money, limited government debt, and no bubbles. A gold standard saves political types from themselves; it forces nations to make choices. No currency should be held hostage by the inherent weakness of man.

During the Johnson administration, the political debate revolved around the need for guns or butter. Up until recently, we haven't required those choices from our politicians; it's been guns, butter, health care, bridges to nowhere . . . the list goes on. And there is an illusion that we haven't been paying for it, but we have—through the devaluation of the dollar and the accumulation of future government liabilities. After all, government debt is simply a tax on future private-sector production with interest. And unless our government wants to admit that U.S. debt is a Ponzi scheme that can be financed only through rollovers, the buyers of our debt must be convinced at all times that we can pay back every dollar borrowed.

But lately they haven't been fooling as many as they used to; people out there are starting to realize it—people feel what is happening. You

can delude the masses for only so long. From tea party rallies to Occupy Wall Street, their lives embody the effects of a fiat currency. Their voice is born from the erosion of the middle class.

Remember—with a fiat currency, governments can incur tremendous amounts of debt and can always (ostensibly) make good on their principal and interest payments because they can print money. Default comes through inflation instead. Default via inflation is worse than actual default. The political types will always implicitly default via inflation before they explicitly default. An inflationary default is surreptitious in nature and so much more palatable at the start.

So go ahead—call me a dinosaur, claim that I am archaic and a barbarous relic . . . I admit it, I believe in the virtues of the gold standard. In the following chapter, we will see that throughout history a deliberate increase in the supply of money has disastrous consequences—and provides a foundation for my argument that the current increase in the money supply courtesy of the Fed has led to what I believe to be the biggest bubble ever.

So fasten your seatbelts—it's going to be a bumpy ride. In the next chapter, we travel all the way back to the 1600s.

Notes

1. Office of the Federal Register, "Richard Nixon," containing the public messages, speeches, and statements of the president—1971 (Washington, DC: U.S. Government Printing Office, 1972), 886–890.
2. G. Edward Griffin, *The Creature from Jekyll Island: A Second Look at the Federal Reserve* (New York: American Media, 2010).
3. Ron Paul, *End the Fed* (New York: Grand Central Publishers, 2010).
4. Although it is unclear if Tim Geithner actually watched Nixon deliver his speech, we do know from Watergate tapes later obtained that Nixon's staff struggled with preempting *Bonanza.*
5. Griffin, *The Creature from Jekyll Island*.