

*It is well enough that people of the nation do not understand our banking and monetary system, for if they did, I believe there would be a revolution before tomorrow morning.*

**Henry Ford**

Most people have always found the discussion of economics rather boring. What is the only thing worse than a boring discussion of economics? It's one that's confusing too. Therefore, I am going to attempt to make a rather boring and confusing topic both entertaining and understandable. Your money is important. Unfortunately, most people do not understand how our system of money works. Ask somebody, "Where does a dollar come from?" If the question isn't greeted with a blank stare and a yawn, check for a pulse.

As with all types of systems sooner or later there are occasional problems. Recently, many successful investors are pointing out that the United States might soon have a problem with its monetary system. Though that sounds benign enough, it is anything but benign. Therefore, it is important to look at a brief history of our monetary system (which I will classify as the good, the bad, and the ugly), what it looks like today, a few of the potential problems, and a few possible outcomes.

#### The Good

Prior to 1913, the United States was experiencing some of the best economic growth that it had ever seen. This was accomplished on a gold standard with a free banking system for over 130 years. Though far from perfect, this system went hand in hand with achieving one of the highest standards of living ever seen. A gold standard is the idea that gold is actually money. (If you try to pay for something in gold today you'll be laughed at. I know, because I tried once). The old banking system went something like this: If you had gold, you went to a bank to store it. The banker then held your gold for you and paid you interest. In exchange for your gold the banker issued these things called bank notes. You could later return these notes to your bank and the bank would give you your gold back. In the meantime, you could then use these bank notes to buy things, rather than lugging gold around in you pockets. Lugging gold around was obviously unsafe and cumbersome. Some places, such as the local saloon, preferred to accept gold rather than bank notes. Bank notes weren't quite gold and had a little more risk to them as described below.

The banker, on the other hand, that held your gold, lent your gold out to businessmen for local projects such as building a saloon. Banks created these loans by simply giving out a few extra additional bank notes. In fact, banks frequently gave out more bank notes than they had gold in the vault. This was permissible, but a little risky if you had your money in the bank. As a depositor, you received a little interest on your gold as compensation for this risk. There was the risk that the bank might not have enough gold in the bank if all the bank notes were presented to the bank all at once. This is what people called a "run on the bank." This is similar to what happened to the Bailey Building & Loan, in the movie "It's a Wonderful Life." These were relatively rare occurrences, but certainly made headlines. Therefore, depositors needed to know an awful lot about their local banker. Is the banker honest? What is the bankers' track record? Does the banker drink? What types of loans is this banker making? The government's role in this was simple. If you found a gold nugget, the government would exchange minted gold coins, of same value, for your nugget. No more, no less.

#### The Bad

By 1913, the Federal Reserve Act was passed which started the process of going off the gold standard. Instead of the Bailey Building & Loan holding your gold and handing out money, it was centralized at the Federal Reserve, a private bank, and the U.S. Treasury. The Federal Reserve now gave out Federal Reserve notes and the U.S. Treasury held your gold. The process of going off the gold standard was finalized for the United States by Franklin D. Roosevelt with his signing of The Gold Reserve Act on April 19<sup>th</sup>, 1933. This act stopped the convertibility of your paper money into gold, ordered all privately held gold back to the U.S. Treasury, and made gold illegal for citizens of the United States to hold. I wouldn't blame FDR for doing this. People began to worry about the soundness of paper currency and wanted their gold back, so FDR prevented a run on the U.S. Treasury. In effect the government confiscated all the gold from U.S. citizens. Fortunately, on Gerald Ford's first day in office, he made it legal for U.S. citizens to own gold again. Though gold has been around for 3,000 years, it could almost be classified as a newer investment for most U.S. citizens and investors. Luckily, the U.S. Treasury now sells back its previously confiscated gold to the U.S. citizens for the sum of 570 per oz.

### The Ugly

Meddling in the monetary system wasn't enough for our group of government do-gooders. Instead of the local banker, the Federal Reserve began to set interest rates and print money at will. Politicians love this idea. They can now spend an endless amount of money on projects that nobody seems to care about or benefit from. As pointed out before, what gave the value to a bank note, issued from your local bank, was the confidence you had in the banker and bank's financial position. Old fashioned bankers had to be very careful how many bank notes they issued, how much gold they had to cover their notes, and bankers had to be very careful about their reputation. They didn't want depositors withdrawing their gold all at once creating a run on the bank. The Federal Reserve, however, left the stodgy old gold standard in the past and could now be more flexible. The Federal Reserve can now print money during a boom, a bust, an inflationary environment, or a deflationary environment. In fact, they print money for what seems to be no reason at all. The biggest buyer of government debt is the Federal Reserve Bank with money they create out of thin air. The Federal Government has been able to incur over \$8 trillion in debt under this flexible system. Oddly, there is only 143 million ounces of gold held in the U.S. Treasury which equates to \$80 billion dollars. Most people can't fully understand what \$8 trillion in government debt actually means, but they can understand it better by knowing there is only \$80 billion to cover it. This might be a problem, and would have certainly worried an old fashion banker.

One problem that can appear is inflation. As inflation sets in, reasons are given to not worry. Classic signs such as rising energy and gold prices are dismissed, and the wrong reasons are used as an explanation. For instance, experts claim, "We are running out of energy." Alan Greenspan recently blamed the threat of terrorism for the soaring gold price, but as Steve Forbes aptly stated in the Wall Street Journal on February 01, 2006, "Most economists hate to hear this, but for a variety of reasons, gold is to monetary policy what the North Star is to determining location. Gold's intrinsic value hardly changes. Its price fluctuation in dollars reflects not a change in the value of gold but a change in the real worth of the greenback. This is absolutely basic." Too many dollars are being printed now and many prices are starting to reflect this. In other words, it is not that prices are going up; your dollars are starting to go down.

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