



## **Fox in the Henhouse**

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*Lenin is said to have declared that the best way to destroy the capitalist system was to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily. And while the process impoverishes many, it actually enriches some.*

John Maynard Keynes

*The Economic Consequences of the Peace*, 1919

In 1971, the fox gained control of the henhouse when President Nixon ended the Bretton Woods gold standard currency system. That move set us on a path of debauching our currency through inflation, just as Vladimir Lenin predicted nearly a century earlier.

The Bretton Woods system had its flaws, but at its core it depended on US dollar convertibility into gold at a fixed price of \$35 per ounce. This convertibility imposed a limit on government borrowing and money creation. If faith in the value of dollar receipts were lost, central banks would demand their payments in gold, and in 1971, that is exactly what happened. Since then, we have counted on the Federal Reserve to preserve the purchasing power of our money. We have depended on the fox to protect our hens.

### **Our founders sought to prevent this**

The need for sound money was well known by the founders of this country. The Revolutionary War found the Continental Congress short of the one thing needed to fight a war — money (more specifically, gold). Lacking the power to tax, the Continental Congress issued Continentals to pay for the war. By 1780, Continentals were worthless and, despite promises of gold backing, were never redeemed. Those who accepted these letters of credit during the course of the war, such as George Washington, suffered considerable losses. Congress and the states also borrowed from American and European banks. The banks were repaid in full by the 1790s.

With this background one can understand the founders' visceral dislike of fiat money and banking. As a result, the founders all agreed on three basic economic principles:

1. Private ownership — Government defines what property is, not how it should be used. An owner retains the right to determine the best use of his property. The



- government should encourage widespread property ownership and protect it from infringement by others, including — perhaps especially — by government itself.
2. Free Markets - Everyone must be free to sell their property to anyone, at any time and place, at a mutually agreeable price. Government's role should be confined to the enforcement of contracts.
  3. Sound money – There must be a medium of exchange whose value is constant (or nearly so) and certain.

With these principles in mind, the founders set up government to protect our rights and banking to store our wealth. Over the last 40 years there have been repeated violations of each of these principles. The fox sits in power, not because of a failure of these principles of capitalism but because of a failure to adhere to them.

The most basic purpose of government is to protect the rights of citizens. The ability to acquire and maintain property is not only fundamental to our economy but also, importantly, crucial to our society itself. People are not perfect. There will always be those who would rather steal than acquire property lawfully. If government does not protect our right to acquire and maintain property, people will be reluctant to expend their efforts in doing so, and the economy will suffer.

Government protection of those rights is enshrined in the Fifth Amendment, which assures citizens of due process and prevents unlawful confiscation of property for public use. This basic function of government has been degraded and perverted over the years. A recent example was the *Kelo v. City of New London* decision, which permitted the government to take private property by eminent domain. Debate over how to best secure property rights has proceeded over centuries, and the founders' first two principles — private ownership and free markets — have been sufficiently adhered to, at least in spirit, for our capitalist system to function.

The violation of the third principle — sound money — has critically weakened our property rights and created a distrust of free markets. This violation places the first two principles at grave risk. All people are still created equal, but without the bounds of sound money, some are afforded privileges not available to all, while others enjoy prosperity more due to luck than to skill.

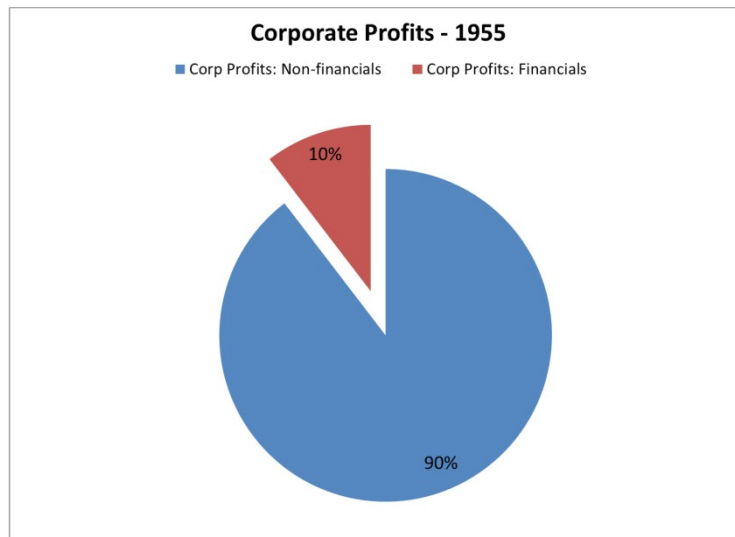
### **The power of the financial sector**

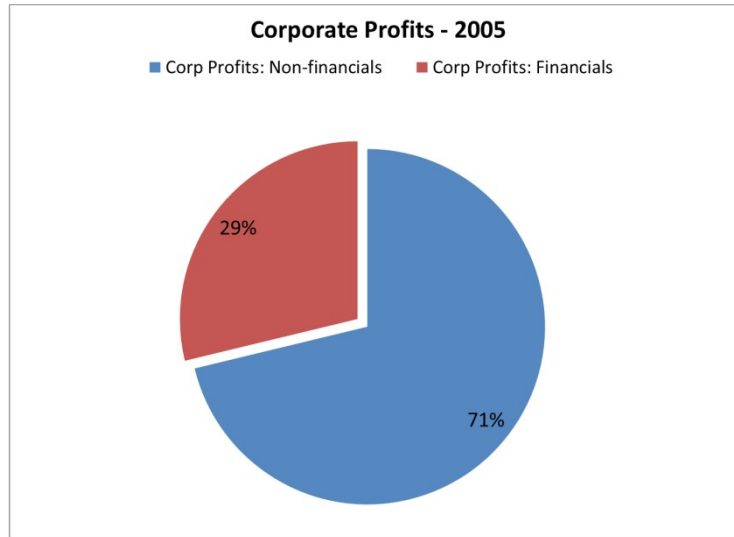
The Keynes quotation at the beginning of this paper rings as true today as in 1919. There is daily debate about the equity of the distribution of wealth. The Tea Party was born out of resentment of arbitrary government confiscation of property. Bankers have reaped windfalls beyond their desserts and are rightly demonized for perverting government power for their benefit.



The American dream, where hard work and thrift are sufficient to build wealth, has turned into a nightmare. The accumulation of wealth has become a gamble. Those who bet correctly — John Paulson — or who bribe the dealers — bankers benefitting from TARP — win at the expense of their fellow citizens.

Banks are essential to the efficient functioning of a capitalist system. They ease the frictions of commerce and, when run conservatively, accelerate the accumulation of wealth for those who produce it. For providing this service, they deserve to be compensated a portion of that wealth. But when it becomes more profitable for banks to speculate with their deposits than to serve the community, they have moved beyond the acceptable boundaries of the profession. When their profits are out of proportion to the services they provide, they are transformed from facilitators to predators. That is where we stand today, as the financial sector has claimed a dramatically larger share of corporate profits over the last half century:





Wake up, America! The banks are no longer greasing the wheels of commerce. Most citizens are still working within the bounds of the system the founders created, but the banking and government sectors have grown beyond their useful functions. They have systematically stolen and squandered the rewards of the last 50 years, which rightfully belong to the citizens of this country. The financial industry, the government and the apologist economists have created economic models to justify their theft, but these models are frauds. Too big to fail? Systemic risk? Stimulus? Says who — economists employed by government and the financial industry? One shouldn't depend on the fox to design the henhouse fence, gate and lock.



How much have we lost? Here's a look at the US household balance sheet over time:

<b>Balance Sheet US Household Sector</b>				
	<b>7/1/1971</b>	<b>1/1/1985</b>	<b>1/1/1995</b>	<b>7/1/2010</b>
<b>Assets</b>				
<b>Financial Assets</b>				
Deposits	594.11	2,403.13	3,217.41	7,659.20
Credit Market Instruments	238.36	891.75	2,188.52	4,190.94
Treasuries	78.36	298.52	878.27	1,083.20
Stocks/Mutual Funds	743.45	1,202.80	4,662.23	12,245.56
Privately Held Equity	687.97	2,419.54	3,338.11	6,513.33
401K/Pensions	282.43	1,806.27	5,103.73	12,261.89
Security Reserve	4.60	20.99	113.46	698.21
Insurance Reserves	135.42	254.90	533.34	1,299.98
Misc	30.43	117.47	317.80	812.79
<b>Total Financial Assets</b>	<b>\$2,795.13</b>	<b>\$ 9,415.37</b>	<b>\$20,352.87</b>	<b>\$46,765.10</b>
<b>Fixed assets:</b>				
Total Real Estate	1,104.25	4,866.05	8,583.80	18,266.01
Residential Real Estate	938.48	4,250.04	7,819.86	16,551.99
Non Profit Real Estate	165.77	616.01	763.94	1,714.03
Durable Goods	374.48	1,299.44	2,461.16	4,596.59
Non Profit Equip & Software	8.96	49.30	95.09	289.06
<b>Net fixed assets</b>	<b>\$1,487.69</b>	<b>\$ 6,214.79</b>	<b>\$11,140.05</b>	<b>\$23,151.67</b>
<b>Total assets</b>	<b>\$4,282.82</b>	<b>\$15,630.16</b>	<b>\$31,492.92</b>	<b>\$69,916.77</b>
<b>Liabilities</b>				
<b>Current liabilities:</b>				
Accts payable (Credit Cards)	143.47	536.02	1,024.55	2,408.85
Bank Loans	4.95	19.28	41.57	257.91
Other Loans	21.95	70.67	108.99	135.92
Trade Payable	7.12	21.81	94.99	254.87
Margin	8.47	30.61	69.85	234.61
Deferred/Unpaid Life Ins Prem	5.36	15.07	16.98	22.56
Not for profit Debt	-	53.64	96.52	266.30
<b>Total current liabilities</b>	<b>\$ 191.32</b>	<b>\$ 747.10</b>	<b>\$ 1,453.45</b>	<b>\$ 3,581.02</b>
<b>Long-term liabilities:</b>				
Mortgage payable	302.74	1,304.44	3,191.20	10,124.69
Commercial Mortgage payable	11.40	31.71	100.31	236.66
<b>Total liabilities</b>	<b>\$ 314.14</b>	<b>\$ 1,336.15</b>	<b>\$ 3,291.51</b>	<b>\$10,361.35</b>
<b>Total liabilities:</b>	<b>\$ 505.46</b>	<b>\$ 2,083.25</b>	<b>\$ 4,744.96</b>	<b>\$13,942.37</b>
<b>Net Worth</b>	<b>\$3,777.36</b>	<b>\$13,546.91</b>	<b>\$26,747.96</b>	<b>\$55,974.40</b>

In isolation, the gains actually look good, but when you consider the loss of value in the dollar, a truer picture emerges. In 1971, household net worth was 107,924,571 ounces of



gold. At today's gold price, household net worth only buys you 39,981,714 ounces. The price we've paid for the "flexibility" of floating exchange rates is, at minimum, 67,942,857 ounces of gold, or about \$95 trillion. That isn't chicken feed.

### **Who's responsible?**

The culprits in this great robbery are the Federal Reserve, the banking system and the politicians. As Milton Friedman said, inflation is always and everywhere a monetary phenomenon. There is no institution that carries more blame for our loss of wealth than the Fed. It has systematically looted our wealth over the last 40 years by allowing the dollar to fluctuate wildly and destroying its value. The beneficiaries of this theft are the banks and the government. The politicians have impoverished us through wasteful spending — on wars and boondoggles alike — while the banks have benefitted by receiving the new money created by the Fed before anyone else does. Banks are able to deploy this new "capital" before it depreciates.

Debauching the currency has many effects. A fluctuating currency sometimes favors creditors and sometimes benefits debtors. It exacerbates inequality. Not all citizens have the same level of financial understanding or the ability to rearrange their financial affairs to offset the effects of a fluctuating currency. Those on fixed incomes are particularly ravaged; they must navigate financial markets made more volatile by the fluctuating dollar. Without a large cushion of excess capital, mistakes are often fatal to living standards. Banks, on the other hand, have greater knowledge and the wherewithal to hedge risks that ordinary citizens cannot afford or understand.

Most modern economists overlook the distributional effects of a floating currency, because they concentrate on aggregates rather than micro effects. Relative price changes also occur in a stable currency system, but these relative changes are further distorted by inflation.

The recent real estate inflation is evidence of this distributional effect. The Fed ignored the rapidly falling dollar, and speculators bid up the dollar price of real estate (and other real assets such as commodities). Those who owned real estate prior to the inflation benefitted to a degree that renters did not. It wasn't a zero sum game. As inflation reached its height, those with less knowledge of financial affairs were lured into purchasing assets at inflated prices using easy credit from the banks and the government. The subsequent collapse left these citizens even poorer than before the inflation.

The fluctuating dollar introduces a level of uncertainty into the economy that restrains investment. Coping with uncertainty has real costs and reduces the efficiency of a capitalist economy. We've heard a lot in the past few years about the financial weapons known as derivatives, which are a side effect of a fluctuating currency. Companies faced with unpredictable interest rates and commodity prices hedge these risks with derivatives.



These hedges tie up capital that is then not available for productive investment. Incompetently managed, they turn into speculative traps.

A number of companies went bankrupt in 2008 because their attempts to hedge wildly varying costs created losses in excess of their capital. It should not escape your attention that the financial industry, which manufactures derivatives, profits from these bankruptcy sales.

Many are eager to blame our problems on globalization and the decline of manufacturing in the US, but this is not the answer. The US is the world's largest manufacturing economy by a wide margin. Manufacturing employment, not manufacturing, has fallen as a function of productivity. Improved productivity is how we increase our national wealth. The financial industry, not a decline in manufacturing, should be blamed for our current impoverishment.

The financial industry has grown large and influential because it occupies a preferential position in the economy. It benefits from the volatility created by the fluctuating dollar and from its ability to borrow directly from the Fed, a privilege not accorded to other corporations or individuals.

### **The path to economic growth**

The future of our economy and nation depends on a return to the principles laid out by the founders of this country. A return to sound money is required to ensure that our property rights are not further degraded. The Fed has not been up to the task, and a return to the gold standard may be the only option. With leeway to deviate from a standard measure of the dollar, future Federal Reserves will be tempted to use monetary policies to repair bad fiscal policies formulated by politicians, rather than letting economic cycles run their course.

Sound money is an essential component of the framework for economic growth, but it does not function in isolation. If the Fed focuses exclusively on providing a stable medium of exchange and accomplishes that task with minimal volatility, it will have done everything it can to foster growth. If economic growth suffers within that framework, the cause will be more easily isolated and corrected.

As investment fiduciaries, we invest our client's assets for their benefit only. We avoid or disclose conflicts of interest. By failing to maintain a stable value of our money and systematically favoring the financial industry, the Federal Reserve has breached its fiduciary duty to the American people. We demand justice and a return to sound money.



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