BANKNOTES - NELSON NASH'S MONTHLY NEWSLETTER

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The Infinite Banking Concept™
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Nelson Nash, Founder

BankNotes archives are located on our website:
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Nelson Nash's live seminars for the next two months (The seminar sponsor or contact person is listed with phone and e-mail address in case you want to attend)

Tuesday-Wednesday, 9-10 September, Lufkin, TX – Ricky Heard 936-564-1735, ricky@cbhins.com

Friday-Saturday, 12-13 September, Hillsboro, TX – Nancy Jackson 254-582-3565 or 254-582-3037, nancy@bcbstexas.com

Thursday-Friday, 18-19 September, Little Rock, AR - Becky Rice 501-221-7400, becky@rebeccarice.net

Friday-Saturday, 26-27 September, Lenexa, KS – Levi Clock 816-225-3715, lclock@kc.rr.com

Friday-Saturday, 3-4 October, Ft Worth, TX, James Neathery 817-790-0405, jcneat@gmail.com

Friday-Saturday, 10-11 October, Greenville, SC, Scott Crutchfield 864-303-3746, info@scottcrutchfield.com

Wednesday-Thursday, 22-23 October, Indianapolis, IN, John Rafferty 317-571-2365, john_rafferty@glic.com

24-25 October, Flint, MI, Gina Wells 810-579-5808 Toll Free (877) 579-2224, gina@advanced-capitalgroup.com

Here is a listing of Nelson's newly added Book Recommendations

33 Questions about American History You're Not Supposed to Ask – by Thomas E. Woods, Jr.

Tuition Rising: Why College Costs So Much - by Ronald G. Ehrenberg

Free Banking: Theory, History and a Laissez-Faire Model - by Larry J. Sechest

Nelson's Favorite Quotes of the Month

The truth, indeed, is something that mankind, for some mysterious reason, instinctively dislikes. Every man who tries to tell it is unpopular, and even when, by the sheer strength of his case, he prevails, he is put down as a scoundrel. – H. L. Mencken

As the Roman Empire declined the resources of the farmers were exhausted by outrageous burdens of all taxes, the fields were abandoned, and the cultivated land reverted to waste. -- Lactantius

"At the beginning of the dynasty, taxation yields a large revenue from small assessments. At the end of the dynasty, taxation yields a small revenue from large assessments." -- Ibn Khaldun

"There is a limit to the taxing power of the state beyond which increased rates produce decreased revenues." - Calvin Coolidge

"Another difference between death and taxes is that death is frequently painless." - Anonymous

"The relative stability of profits after taxes is evidence that the corporation profits tax is in effect almost entirely shifted; the government simply uses the corporation as a tax collector."-- K.E. Boulding

The following articles are Nelson's favorite finds from the last month's reading

Two of my favorite writers have "done it again."
- Nelson

"General Motors and the Intellectual and Moral Bankruptcy of Wall Street"

by Karen De Coster and Eric Englund

As punctuated by General Motors' second quarter (6/30/08) loss of $15.5 billion, General Motors is a company in financial distress. In its attempt to survive the current economic milieu, management has been looking to throw excess weight overboard to keep the company afloat. GM is trying to ditch its declining Hummer brand, and it has been rumored that Pontiac and Buick may be fire-sale material. [1] The company has been offering massive rebates on its trucks, along with 72-month, 0% financing in an attempt to unload its weighty inventory. In spite of this, along with sagging car sales, [2] a tightening credit market, junk-rated bonds, a doomed balance sheet, massive production cuts, [3] substantial layoffs, zooming gas prices, and eroding cash flow, Merrill Lynch analyst John Murphy had maintained a "buy" on GM with a target of $28 per share.

Let's step backwards a bit. On June 25, 2007, Wall Street powerhouse Morgan Stanley put out a "buy" recommendation with respect to General Motors' common stock. Robert Barry, Morgan Stanley's star analyst, proclaimed a 52-week target price of $42 per share. Less than five months later, on November 7, 2007, Wall Street analysts were stunned by General Motors' staggering third-quarter (9/30/07) loss of $39 billion – one of the largest bookkeeping losses in history, which was mostly related to the writedown of deferred tax assets.

Fifty-three weeks after Morgan Stanley's buy recommendation, GM's stock hit a 54-year low of $9.98 per share – on July 2, 2008, after Merrill Lynch's recommendation had gone from a "buy" to "underperform" (i.e., sell) on that day. In one sweeping move overnight, Merrill Lynch analyst John Murphy cut his target price on GM by a whopping 75%, reducing the target price from $28 to $7. So how is it that GM suddenly went from respectability to mediocrity – in one analyst's mind – overnight? In fact, why did it take until July 2008 to concede that GM was on life support? Wall Street, belatedly, is willing to acknowledge the fact that General Motors is teetering on the verge of bankruptcy.

Accordingly, key questions come to the forefront. How did any stock analyst, worth his salt, get blindsided by the aforementioned $38.3 billion writedown of deferred tax assets? Are Wall Street's Ivy League-educated MBAs able to comprehend advanced accounting and finance? Has rigorous security analysis, on Wall Street, been supplanted by self-serving cheerleading and inane platitudes with the objective of transferring wealth from the masses to the Wall Street elites?

As Benjamin Graham and David L. Dodd so eloquently stated in their classic 1934 book *Security Analysis*, "The correct calculation of the asset values and their relationship to securities or creditors claims depends on the purposes of the analyst." Therefore, to answer the above-posed questions is simple. Wall Street has little to do with disseminating competent securities analysis and advice to average "investors," and has much to do with transferring wealth from Main Street to Wall Street – and, for the most powerful Wall Street brokerage houses, doing the bidding of the government's Plunge Protection Team.

For Wall Street analysts to claim "surprise" at GM's massive deferred tax asset writedown, during fiscal year 2007, and to finally discuss (in mid-2008) General Motors' financial condition in terms of a possible bankruptcy, indicate that low-level fluff is easily passed on to Main Street "investors" under the guise of serious analysis. At the very least, earnest auto industry analysts should have been sounding the negative-outlook alarm after General Motors published its December 31, 2006 annual report – yet Wall Street was shouting "buy, buy, buy." One must wonder, again, if any of Wall Street's analysts are even capable of reading a financial statement. If the answer is affirmative, then honest analysts would have drawn the same conclusion as Eric Englund did in his July 9, 2007 essay. Here is an excerpt:

To analyze General Motors' 12/31/06 FYE financial statement is to understand that this once great company is likely heading towards bankruptcy. Here are the gruesome details:

- GM's "as stated" net worth is **negative** $5.4 billion
- By fully discounting intangible assets, which includes *deferred tax assets*, GM's net worth is arguably **negative** $48.5 billion (refer to Note 13 of GM's 12/31/06 financial statement)
- GM's as stated working capital is **negative** $3.7 billion
- By fully discounting *current deferred tax assets*, GM's working capital drops to **negative** $14 billion
- General Motors' total liabilities amount to a staggering $190.4 billion
- GM's net loss, in 2006, was nearly $2 billion

With GM's September 30, 2007 third-quarter writedown of $38.3 billion in deferred tax assets, GM's financial condition – at fiscal year-end December 31, 2007 – validates Eric's above-shown analysis. Accordingly, GM's 12/31/07 as stated working capital and net worth positions stood at *negative* $10.2 billion and *negative* $37.1 billion, respectively. Then, at March 31, 2008 (GM's most recent filing), the company's financials reveal a negative net worth of $41 billion. To compound this company's downward spiral, with the latest quarterly loss of $15.5 billion, GM's net worth arguably stands at negative $56.5 billion. These are the financial indices of a company on the verge of bankruptcy. To put things into perspective, GM's market capitalization stands at under $7.5 billion, which is among the lowest of the 30 firms in the Dow Jones Industrial Average.

On the surface, it appears that Graham and Dodd's invaluable book *Security Analysis* is unfamiliar to most securities analysts. If a financial analyst understood the nature of a deferred tax asset, and that such an asset is properly deemed an "intangible" asset, then the course of action to take is quite elementary. As Graham and Dodd stated, "It is customary to eliminate intangibles in the computation of the net asset value, or equity, per share of common stock."

In the case of General Motors, a competent analyst would not have been surprised by the massive writedown of deferred tax assets. After all, such an analyst would have already fully discounted the intangibles in order to derive a conservative financial condition. The fact that General Motors eventually wrote down these intangible assets merely reflects the financial picture that a principled financial analyst previously would have drawn.

The point here is that GM is so unprofitable that its top-level management realized they had to come clean and write down the value of its deferred tax assets because it became completely unpredictable as to when the company would actually return to making a profit, and thus use that tax asset against any future tax liability it incurs. Essentially, GM is uncertain about its ability to generate profits in the near future, and correspondingly, its use of its tax shield is in doubt. According to accounting rules, GM must recognize the impairment of the tax asset, hence the write-off. This is a huge indicator of management's pessimism about the coming years. GM, in writing down its tax assets as it did, made a negative judgment about the uncertainty of future economic events and their outcome. In view of that, this is a company heading toward bankruptcy, and executive management is fully aware of how close they are to being unable to prolong the dog-and-pony show.

So, just how savvy are some of Wall Street's best and brightest analysts? Nine days before GM's deferred tax asset writedown bombshell, UBS upgraded its rating of GM to a "buy." On September 13, 2007, Citigroup initiated coverage and issued a buy recommendation. Other Wall Street heavyweights, in 2007, that had weighed in with "upgraded" opinions of GM included Banc of America Securities, Goldman Sachs, J.P. Morgan, Lehman Brothers, and

Deutsche Securities. One must heed Graham and Dodd's words as to what purpose is behind a securities analyst's recommendation. But then again, Wall Street analysts long ago abandoned their roles of providing independent expertise, and instead turned to selling their firm's investment banking services. Mark Reutter writes:

Stock analysts have long been fixtures at investment banks that both broker (that is, sell) stocks and bonds to the public and underwrite new security issues for companies. With deregulation of brokerage commissions in 1975, which ended the practice of fixed-rate minimum commissions, investment banks found their brokerage business drying up, undercut by Charles Schwab & Co. and other discount brokerages.

Trading fees plummeted and analyst reports no longer paid for themselves. As a result, the role of the analyst shifted from providing relatively impartial information for brokers and their clients to boosterish tie-ins with corporate clients, such as using the research reports to hype a company's prospects and promoting initial public offerings (IPOs) on investor "road shows."

So now, with the two services – investment banking and stock analysis – conveniently commingled, and thus creating a huge conflict of interest, a dealmaker's sales literature is passed off as serious and useful analysis of the financial markets, leading Main Street investors – who tend to follow these recommendations – seriously astray.

Also ignored by Wall Street analysts was the banking community's loss of confidence in General Motors. A strong indicator as to how nervous GM's bankers were, pertaining to this automaker's viability, emerged when General Motors' banking syndicate amended GM's line of credit on July 20, 2006. This borrowing facility went from a $5.6 billion unsecured line of credit down to a $4.6 billion line of credit, of which $4.48 billion was secured. This 97%-secured bank line had a termination date of 2011. This arrangement was described as being a "positive action toward additional financial flexibility." Positive for whom? This meant that the holders of the new loans, which were secured by collateral, had priority over GM's unsecured bonds. A default on the loans before the bonds are paid off would mean that bondholders would be left high and dry. This caused another credit-rating cut to GM's bonds, which were already junk. As of March 31, 2008, GM's borrowing facility remained substantially the same. Nonetheless, this still begs the question as to whether or not Wall Street analysts read 10-Qs anymore?

But the agony does not end there. Adding to GM's plentiful wounds, S&P announced that effective after the close of trading on July 17, 2008, General Motors would be dropped from its flagship S&P 100 index. A vital component of the Index of Leading Indicators, there has been no comment from S&P as to why the purge occurred. Though a drop from the S&P is not unique, in an historical sense, the most important index of large-cap US stocks must not see an enduring future for General Motors. In addition to that news, market participants have little confidence in General Motors. The credit derivatives market has priced in a 75% probability that GM will default on its loans within the next five years, and a 25% chance that it will default within one year.

Perhaps the next buzzword that journalists and Wall Street prophets of profit will swoon over will be "going concern." In financial accounting, "going concern" means that a company must be financially sound enough to continue operating as a business entity. A company's value, as conveyed by its balance sheet, must reflect the value of the company in the long-term (beyond one year). Management has a duty to act on the principles of going concern when preparing financial statements. They must assess whether or not there are any material items that create uncertainty about an entity's ability to continue as a going concern for and beyond the foreseeable future. Material items that bring forth doubt about an entity's viability must be disclosed in the financial statements. A company facing bankruptcy due to financial items that give rise to material uncertainties is not a going concern. Auditors who form an opinion on financial statements are not required to devise and conduct specific audit procedures to validate the going concern assumption. However, they are required to evaluate conditions and events *that indicate the* *potential* for going-concern problems.

In 2001, when 257 publicly-traded companies went bankrupt, a survey of 202 of these companies revealed that only 48% of them had audit reports that included the auditor's explanatory paragraph expressing doubts about the company being a "going concern." This must be considered a mammoth failure for the audit-accounting industry as a whole. Considering all the significant factors driving GM's financial deterioration, the buzz on the Internet contains occasional references about whether or not a "going concern" qualification *should* or *will* be issued to General Motors. Certainly, that is highly unlikely, since no public accounting firm is likely to accelerate the downfall of its premier client. [4]

Considering GM's shrinking profit margins, mounting debt load, and onerous legacy obligations, [5] there is not enough cash from operations [6] to pay the rising cost of its debt expense or invest in future operations. Thus we have continued to write about General Motors and the fact that it operates on the verge of insolvency. The trend for GM has been the build-up of negative equity, negative working capital, insurmountable losses, and previously, its only profits were coming from its finance arm until it sold a majority stake in GMAC. In a world of $4 + gasoline, GM is now caught with an impractical product mix dominated by pickup trucks and SUVs.

A well-capitalized automaker could see its way through these difficult economic conditions and take the appropriate time and steps to develop a more suitable lineup of automobiles. However, General Motors' fragile balance sheet will not see this automaker through to better times. GM will have to declare bankruptcy and Wall Street, as usual, will absolve itself of such a self-serving clustering of buy recommendations pertaining to General Motors' common stock. You can be certain that the big brokerage houses were offloading their own GM stock (and for those well-connected clients) to the poor saps on Main Street who trusted Wall Street's analysts. And thus the deception and the wealth transfer continue.

References

- Graham, Benjamin and David Dodd. 1988. *Security Analysis*. New York: McGraw-Hill.
- Mish's Global Trend Economic Analysis.

Notes

Past articles on GM (by Karen DeCoster and Eric Englund) are here and here.

[1] GM CEO Rick Wagoner claims (as of July 25, 2008) that only Hummer is on the block, and no other brands will be eliminated or sold.

[2] Auto sales in the US are at a 16-year low. GM's sales fell 26% in July. The devaluation of the US dollar makes GM's Saab brand costly to import and sell here in the US. Sales of Saab were down 29% in the first half of 2008.

[3] For Q2 2008 (2nd quarter), GM's vehicle production dropped to 835,000, down 27% from the previous year.

[4] A public accounting firm is unlikely to want to be responsible for lowering stockholders' and creditors' confidence in a company, especially a venerated giant like General Motors. The New York State Society of CPAs states, "The fear is that a going-concern opinion can hasten the demise of an already troubled company, reduce a loan officer's willingness to grant a line of credit to that troubled company, or increase the point spread that would be charged if that company were granted a loan. Auditors are placed at the center of a moral and ethical dilemma: whether to issue a going-concern opinion and risk escalating the financial distress of their client, or not issue a going-concern opinion and risk not informing interested parties of the possible failure of the company." But the purpose of a financial audit is to add credibility to management's implied assertions that its financial statements fairly represent its financial performance and position *to its shareholders*. Thus the code of silence on "going concern" issues is both contradictory and dishonest.

[5] Roger Lowenstein writes, "After falling $20 billion behind on its pension earlier this decade, G.M. doggedly put money into its plan to catch up. It has also agreed to invest more than $30 billion in a fund to cover future health-care expenses. But these efforts have starved its business." Unfortunately, he follows that comment with a call for the government to take care of social insurance so that the automakers can concentrate on manufacturing cars.

[6] Where this really hurts GM is in the emerging markets, where GM is doing better than in North America. While Volkswagen and Toyota have robust operations in China, GM is

lacking the capital to quickly expand its market in China.

August 5, 2008

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The Myth of the Independent Fed

by Thomas J. DiLorenzo

Ever since its founding in 1913, the Fed has described itself as an independent agency operated by selfless public servants striving to fine-tune the economy through monetary policy. In reality, however, a non-political governmental institution is as likely as a barking cat. Yet, the myth of an independent Fed persists. One reason this myth persists is that statist textbooks have helped perpetuate it for decades.

From 1948 until about 1980 Paul Samuelson's *Economics* was the best-selling introductory economics text. Generations of students were introduced to economics by Samuelson. Although not as popular as it once was, Samuelson's text (now co-authored with William Nordhaus) is still widely used. According to the 1989 edition:

The Federal Reserve's goals are steady growth in national output and low unemployment. *Its sworn enemy is inflation.* If aggregate demand is excessive, so that prices are being bid up, the Federal Reserve Board may want to slow the growth of the money supply, thereby slowing aggregate demand and output growth. If unemployment is high and business languishing, the Fed may consider increasing the money supply, thereby raising aggregate demand and augmenting output growth. In a nutshell, this is the function of central banking, which is an essential part of macroeconomic management in all mixed economies.

Another top-selling economics text has been Campbell McConnell's *Economics*, which echoes Samuelson and Nordhaus's idealistic statism:

Because it is a public body, the decisions of the Board of Governors are made in what it perceives to be the public interest . . . the Federal Reserve Banks are not guided by the profit motive, but rather, they pursue those measures which the Board of Governors recommends. . . . The fundamental objective of monetary policy is to assist the economy in achieving a full employment, noninflationary level of total output.

These are mere wishes, not statements of facts, for there is voluminous evidence that the Fed – like all other governmental institutions – has always been manipulated by politicians.

The Fed as a Political Tool

When the Fed was founded, it was controlled by two groups, the Governors' Conference, composed of the twelve regional bank presidents, and the seven-member Federal Reserve Board in Washington. In 1935 the Fed was reorganized to concentrate nearly all power in Washington. Franklin Roosevelt packed the Fed just as he later filled the U.S. Supreme Court with political sycophants. Roosevelt appointed Marriner Eccles, a strong supporter of deficit spending and inflationary finance, as Fed Chairman, although Eccles had no financial background and lacked even an undergraduate degree. In those years the Fed was really run by Eccles's political mentor, Treasury Secretary Henry Morgenthau, Jr., and thus ultimately Roosevelt.

Later presidents were no less willing to influence supposedly independent Fed policy. According to the late Robert Weintraub, the Federal Reserve fundamentally shifted its monetary policy course in 1953, 1961, 1969, 1974, and 1977 – all years in which the presidency changed. Fed policy almost always changes to accommodate varying presidential preferences.[1]

For example, President Eisenhower wanted slower money growth. The money supply grew by 1.73 percent during his administration – the slowest rate in a decade. President Kennedy desired somewhat faster money creation. From January 1961 to November 1963, the basic money supply grew by 2.31 percent. Lyndon Johnson required rapid money creation to finance his expansion of the welfare/warfare state. Money-supply growth more than doubled to 5 percent. These varying rates of monetary growth all occurred under the same Fed chairman, William McChesney Martin, who obviously was more interested in pleasing his political master than in implementing an independent monetary policy.

Martin's successor, Arthur Burns, was such a staunch supporter of Richard Nixon that he lost all professional credibility by enthusiastically endorsing Nixon's disastrous wage and price controls. Even though his staff informed him in the fall of 1972 that the money supply was forecast to grow by an extremely robust 10.5 percent in the third quarter, Burns advocated ever-faster growth before the election. *The growth rate in the money supply in 1972 was the fastest for any one year since the end of World War II* and helped re-elect Richard Nixon.

However, President Ford called for slower monetary growth as part of his Whip Inflation Now program, and the Fed complied with a 4.7 percent growth rate. But when Jimmy Carter was elected, Burns again complied with presidential wishes by stepping up the growth rate to 8.5 percent. Carter did not reappoint Burns, but the latter's successors were equally cooperative. The money supply increased at an annual rate of 16.2 percent in the five months preceding the 1980 election – a post-World War II record.

In 1981 Donald Regan, Ronald Reagan's Treasury Secretary, advocated, and got, more rapid monetary growth. A year later the President himself met with Fed Chairman Paul Volcker to lobby for slower growth, which was dutifully produced by the Fed. More recently, Alan Greenspan was just as accommodating to President Clinton.

Both Sides Benefit

The Fed is obviously influenced by the executive branch. But the relationship between the Fed and administrations runs far deeper. As Robert Weintraub observed, such contact has been and continues to be fostered by cross-planting of high-level personnel in both directions. Officials have also met weekly for decades. But personal contact is not necessary for the Fed to allow itself to be used as a political tool. The administration's policy views are generally well known. Economist Thomas Havrilesky has even developed an index of executive branch signaling, based on newspaper accounts of the administration's monetary policy preferences as reported in the *Wall Street Journal*.[2] And as Weintraub concluded, a Chairman of the Federal Reserve Board who ignores the wishes of the President does so at his peril.

The Fed and presidents alike benefit from this arrangement. Economist Edward Kane has argued persuasively that the Fed's ultimate political function is to serve as a political scapegoat when things go wrong. Writes Kane: "Whenever monetary policies are popular, incumbents can claim that their influence was crucial in their adaptation. On the other hand, when monetary policies prove unpopular, they can blame everything on a stubborn Federal Reserve and claim further that things would have been worse if *they* had not pressed Fed officials at every opportunity."[3] In return for this favor, the Fed is allowed to amass a huge slush fund (discussed below) by earning interest income from the government securities it purchases through its open market operations.

A Demand for Inflation?

It is also well established that politicians use the Fed as a tool of money creation to advance their own re-election. As Robert J. Gordon wrote in the *Journal of Law and Economics* more than 30 years ago: Accelerations in money and prices are not thrust upon society by a capricious or self-serving government, but rather represent the vote-maximizing response of government to the political pressure exerted by potential beneficiaries of inflation.[4]

Gordon is wrong in denying that government is inherently capricious and self-serving, but he's got a good point: Politicians are naturally inclined to finance government handouts to special-interest groups with the hidden tax of inflation, which hides the true costs of government from the taxpaying public. Joining with election-minded officials in favor of expansive monetary policies is a low-interest-rate lobby, led, argues Edward Kane, by builders and construction unions and by financial institutions that earn their living by borrowing short to lend long.

The Fed underwrites an enormous volume of research, some of which is very good. But, as *Business Week* magazine once observed: There is disturbing evidence that the research effort of the bank's 500-odd Ph.D. economists is being forced into a mold whose shape is politically determined by the staff of the Federal Reserve Chairman. Some Fed economists admit that political expedience is the rule. Says former Fed economist Robert Auerbach, "the practice at the Bank where I worked was to clear research through the Board of Governors and to 'persuade' economists to delete material that the Board or the Bank officials did not like."[5]

Thus, all Fed research should be taken with a grain of salt. However, one study in particular deserves special attention. In 1992 Boston Fed research director Alicia Munnel published a report claiming to find persistent mortgage loan discrimination against minorities in Boston. The study, used to justify racial quotas for bank loans, was fatally flawed. The data were hopelessly jumbled. Equally important, the report failed to control for creditworthiness – credit ratings, job history, income, and so on. When confronted with these facts by Peter Brimelow and Leslie Spencer of *Forbes* magazine, Munnel admitted: I do not have evidence . . . no one has evidence of lending bias.

Taxpayer-Funded Lobbying

The Fed also uses its privileged position – and especially its multi-billion dollar slush fund generated by interest income on open market purchases – to lobby. Its preferred method is to pressure member banks, which it regulates, to lobby for it. It also recruits a small army of academic researchers, who benefit from Fed research grants, visiting appointments, and invitations to conferences at exotic locations, to testify on its behalf at Congressional hearings.

For instance, in the late 1970s Representative Henry Reuss introduced a bill authorizing the General Accounting Office to audit the Federal Reserve system. It was defeated because, as Reuss later explained, with the Federal Reserve Board in Washington serving as the command center, a well-orchestrated lobbying campaign was mounted, using the members of the boards of directors [of the regional banks] as the point men. In a speech to the American Bankers Association after the GAO bill was defeated, the Richmond Fed's chairman, Robert W. Lawson, congratulated the assembled commercial bankers for their success: "The bankers in our district and elsewhere did a tremendous job in helping to defeat the General Accounting Office bill. It shows what can be done when the bankers of the country get together."[6] Academics conducted themselves in an equally disgraceful way, warning of potential abuses and assuring Congress that the Fed could be trusted to behave responsibly.

For decades, believers in the public interest theory of Fed behavior blamed the Fed's failures to ensure price stability on the agency's incomplete knowledge and difficulty fine-tuning the economy. But research suggests that the Fed's abysmal record in controlling inflation reflects not mere incompetence, but the way in which the Fed is organized.

Until the Fed's creation, there was no overall upward trend in the price level. Inflation occurred during wars, but prices then gradually declined to their former levels. Since the establishment of the Fed, however, there has been a continuous upward surge in prices. Public choice scholars believe that an important reason why the Fed has caused so much inflation is that it benefits from inflation. Since the entire operation has been funded since 1933 from revenue acquired through interest payments on government security holdings, the Fed has an incentive to purchase securities (thereby expanding the money supply) more than it has an incentive to sell them. Purchasing government securities is a source of income to the Fed, whose income is earned by the interest paid on the securities. Selling securities, on the other hand, causes a loss of income.

The Fed is constrained to return excess revenues to the Treasury, but enjoys great discretion over its budget and managed to spend over $2 billion on itself in 1996. Fed officials live quite well on their revenues. As a recent General Accounting Office report revealed: The Fed has 25,000 employees, runs its own air force of 47 Learjets and small cargo planes, and has fleets of vehicles, including personal cars for 59 Fed bank managers. . . . A full-time curator oversees its collection of paintings and sculpture.[7] The Fed held $451 billion in accumulated assets as of 1996, when it was engaged in building for itself several expensive new office buildings. The number of Fed employees earning more than $125,000 per year more than doubled (from 35 to 72) from 1993 to 1996; even the head janitor (known as the support services director) is paid $163,800 in annual salary plus benefits. Money is lavishly spent on professional memberships, entertainment, and travel.

Economist Mark Toma has studied the Fed's spending habits and believes that the Fed does in fact conduct monetary policy with an eye toward how its managers and employees can themselves profit from it. That means instituting a bias toward bond purchases and money creation.[8] Similarly, William Shughart and Robert Tollison contend that the Fed behaves exactly like many other government bureaucracies, padding its operating expenditures by increasing the number of employees on its payroll.[9]

That is, the Fed uses staff expansion to reduce the amount it must return to the Treasury. Thus, when engaging in expansionary policies, write Shughart and Tollison, the Fed can both increase the supply of money and increase the size of its bureaucracy because the two goals are served by open market purchases of securities. Contractionary policies, on the other hand, force the Fed to lower its profits and staff. Because of this unique financing mechanism, argue Shughart and Tollison, the Fed has been more successful in enlarging its employee staff over time than the federal government as a whole. This employment effect, moreover, may partially explain why the Fed has apparently been more willing to engage in expansionary than in contractionary monetary policies.

Regulation as a Political Tool

The Fed also uses its vast regulatory powers for political purposes, rather than to promote the public interest. The Fed's authority is vast, but is most abused through enforcement of the Community Reinvestment Act of 1977. Under the CRA, the Fed must assess a bank's record of meeting community needs before allowing a bank to merge or open a new branch or even an automatic teller machine. An entire industry of nonprofit political activists routinely files protests with the Fed, which must be evaluated before the bank can win Fed approval. The activists typically threaten to stall mergers or branch expansions unless banks give *them* – not the poor in their communities – money, a practice that many bankers consider pure blackmail.

For example, the Chicago-based National Training and Information Center threatened to delay a merger by a Chicago bank unless it received $30,000 to renovate its office. The bank agreed, and also gave $500,000 to other leftist organizations. In Boston, left-wing activist Bruce Marks, the head of the Union Neighborhood Assistance Corporation, filed complaint after complaint with the Fed over Fleet Financial Group's community lending record until Fleet agreed to give $140 million to his organization and to make $8 billion in loans to individuals and businesses favored by Mr. Marks. "We are urban terrorists," Marks explained to the *Wall Street Journal*.[10]

The CRA is frequently used as a means of racial extortion. For example, the Fed, under the direction of former Governor Lawrence Lindsey, found statistical disparities in lending, i.e., the percentage of loans granted by the Shawmut Services Corporation to blacks and Hispanics did not match the groups' proportion in the population. Yet no individuals complained of discrimination and the Fed did not claim to have found any victims. In fact, between 1990 and 1992, when the discrimination allegedly occurred, Shawmut's mortgage loans to blacks and Hispanics more than doubled, and the mortgage rejection rate fell by 45 percent and 26 percent, respectively. However, the Fed employed 150 people to go out and find people who claimed to have been discriminated against by Shawmut and to offer them $15,000 each, effectively robbing the company of $1 million.

Conclusions

Any government monopoly will be corrupt and inefficient, but the Fed may be the worst government monopoly of all. Not only does it operate for its own advantage in the name of promoting the public interest, and offer government officials political cover for their self-interested policies, the Fed also allows no escape. One can at least refuse to do business with, say, the government school monopoly by homeschooling or by sending one's children to private schools. But one cannot avoid the effects of the Fed's monetary monopoly. It is time to depoliticize and denationalize our money.

Thomas J. DiLorenzo [send him mail] is professor of economics at Loyola College in Maryland and the author of The Real Lincoln; Lincoln Unmasked: What You're Not Supposed To Know about Dishonest Abe *and* How Capitalism Saved America. *His latest book,* Hamilton's Curse, *will be published on October 21.*

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Time's Comic Book History

by Thomas J. DiLorenzo

Time magazine recently took a break from advocating the nationalization of health care, a massive enlargement of the welfare state, and swooning over Barack Obama (who's been on the cover seven times to date this year) to compile a list of America's *worst* vice presidents. It's mostly politically-correct baloney with just enough facts to make it appear legitimate to the uneducated reader. One entry in particular – the one for John C. Calhoun as the third-worst vice president (Aaron Burr was the worst, followed by Elbridge Gerry) – caught my eye because almost every single sentence in it is untrue.

The Calhoun entry was written by one Tiffany Sharples. I wondered what kind of background Tiffany has that would have led a *Time* editor to give her the assignment of educating Americans on their vice presidential history. A Google search revealed that she's a "political and health" reporter for the Medill News Service out of Chicago. There's a listing of many of her articles on the Web, the most interesting of which (to me, anyway) is "Drink Pink! Forget Cosmos and Appletinis, Watermelon is This Season's Hot Cocktail of Choice."

The first falsehood in Tiffany's Calhoun entry is her statement that President John Quincy Adams, under whom Calhoun served as vice president, was "a Northern abolitionist." Not true. All of John Quincy Adams's biographers write that he was never an abolitionist per se, even though he made anti-slavery statements. Anti-slavery rhetoric alone did not make one an abolitionist in the nineteenth century. Robert E. Lee called slavery "a moral and political evil," but no *Time* magazine writer would conclude that he was therefore a closet abolitionist.

Adams himself explained why he was not an abolitionist: He felt "bonded" by the Constitution, and its implicit protection of slavery. (Yes, that's right, slavery existed and was protected by the U.S. flag more than twenty times longer (about 90 years) than it was by the Confederate flag). As a diplomat John Quincy Adams supported slave-owners who sought to capture their runaway slaves in foreign countries. He also opposed allowing the British Navy to board American ships suspected of violating the prohibition of the international slave trade (the law of the land in the U.S. as of 1808).

An even bigger falsehood in *Time*'s entry for John C. Calhoun is one in which he is denounced for being an "arch Nullifier." Tiffany and her *Time* editors claim that the principle of nullification was "rejected by Northerners and Southerners alike."

First of all, the principle of nullification is associated with Thomas Jefferson and James Madison and the Virginia and Kentucky Resolves of 1798, which were designed to allow states to refuse to assist in the enforcement of the totalitarian Sedition Act, which made criticism of the government illegal. At the time the Act was being enforced by John Quincy Adams's father, President John Adams. Calhoun did not invent the idea of nullification in order to defend slavery, as *Time* (and the entire Lincoln Cult, for that matter) falsely contends.

As Jefferson wrote on November 10, 1798: "Resolved, that the several States composing the United States of America, are not united on the principles of unlimited submission to their General Government; but that by compact under the style and title of a Constitution for the United States and of amendments thereto, they constituted a General Government for special purposes, delegated to that Government certain definite powers, reserving each State to itself, the residuary mass of right to their own self Government; and that whensoever the General Government assumes undelegated powers, its acts are unauthoritative, void, and of no force . . ." (See William J. Watkins, *Reclaiming the American Revolution: The Kentucky and Virginia Resolutions and Their Legacy*).

When Calhoun advanced this principle to assist South Carolinians in nullifying the 1828 "Tariff of Abominations" he was merely carrying on the Jeffersonian tradition. And of course the nullification of *the tariff* had nothing whatsoever to do with slavery. It was an effort to defend against an early scheme by Northern Yankees to use the powers of the state to financially plunder their fellow citizens in the Southern states.

Moreover, there was no federal law during Calhoun's time (he died in 1850) that was threatening slavery, and was therefore in need of nullifying by slave-owners. The silly, comic book implication of this claim is that heroic champions of morality and racial equality in the Northern states (where slavery existed in some places until the late 1850s) were threatening to end Southern slavery by legislation. This never happened, despite the fact that this lie has been repeated by Lincoln cultists like Harry Jaffa for decades. Indeed, as I write in my book, *Lincoln Unmasked*, the famous Massachusetts abolitionist Lysander Spooner excoriated the Lincoln administration, especially Secretary of State William Seward, for *failing* to seek legal and constitutional means to end slavery, as all the other nations of the earth where slavery existed had done during the nineteenth century. (Spooner had written a roadmap for the peaceful abolition of slavery in his book, *The Unconstitutionality of Slavery*).

It is also untrue that nullification was rejected by Northerners and Southerners alike, as *Time* claims. Up until 1861 many Northern states utilized this important principle as a means of restraining the tyrannical impulses of the central state. In the 1830s, for instance, the Ohio legislature assisted President Andrew Jackson in opposing the first central Bank, the Bank of the United States, by imposing enormous taxes on the branches of the Bank ($50,000 per year on each branch) that had opened up in the state, and issuing a resolution that "the States have an equal right to interpret the Constitution for themselves," and declared the Bank to be unconstitutional. Connecticut, New York and New Hampshire did the same thing, literally quoting Jefferson's Kentucky Resolve of 1798. Some Northern states also nullified the federal Fugitive Slave Act which forced Northerners to hunt down runaway slaves and return them to their owners.

The statements that *Time* magazine makes about nullification in particular, and about John C. Calhoun in general, are pure hokum.

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"The county in Alabama that Bill Bonner mentions in this article is Jefferson (Birmingham)." - Nelson

Gold - The Cash That No Central Bank Manages

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After the biggest spending and borrowing binge in history, Americans need time and money. They need to pay their debts. They need to build savings for their retirements. They need time and money to recover from their mistakes.

What kind of mistakes?

Well, down near the bottom of the ladder, people bought houses they couldn't really afford to own in places they couldn't afford to live. And cars they couldn't afford to run. Those mistakes need to be undone. Which is why there are so many foreclosed houses on the market... and why house prices generally are falling.

S&P/Case-Shiller reports that house prices took their biggest hit ever in the second quarter of this year. They were down 15.4% from the year before.

Further up on the ladder, the rich are now embarrassed by their own housing mistakes. New Yorker magazine reports that it is the 'season of white elephants' in Greenwich, Connecticut. Speculators began huge mansions — in the "Georgian Stockbroker" style, for example, complete with indoor swimming pools, wine cellars, movie theatres, dozens of bathrooms, even ice-skating rinks — and now find the buyers have disappeared. Want to buy a $28 million spec house? Go to Greenwich.

At the investment level there were plenty of mistakes too. Sub-prime mortgage lending dominated the headlines for the last 12 months, but the same reckless spirit found its way into transactions all over the economy. Private equity, IPOs, student loans, shopping malls, fast-food joints — while the going was good, everyone wanted to go along.

And now they all need time and money to pay for their errors.

The baby boomers say they are postponing retirement. Some are going back to the office.

A county in Alabama says it will have to declare bankruptcy.

The FDIC says its "problem list" of banks lengthened by 30% during the second quarter.

Bank earnings fell to their second lowest level in 19 years, says Bloomberg.

In London, tens of thousands of jobs have already been lost in the financial sector, says the Financial Times. IPOs, where the City made much of its money, have "fallen off a cliff."

We have lived through the biggest credit expansion ever. Ahead is perhaps the biggest credit contraction ever. Why? Because it takes time and money to correct mistakes. The bigger the mistakes, the longer and more expensive the correction.

When money and credit flow, they tend to raise prices. You get inflation — first of asset prices... later, of consumer prices. When money stops flowing, prices come down. As George Soros puts it, the willingness to lend is directly related to the value of the collateral. Both tend to rise and fall together.

Currently, lenders are wary and the value of the collateral is falling. Everyone knows house prices are going down. But US stock prices are going down too. Adjusted for consumer price inflation, they've been going down since the end of 1999. That is, a $50 stock is still worth about $50... but the 50 bucks ain't what it used to be. It buys only 1/5th as much oil, for example.

This trend, towards lower asset prices, is likely to last a long time. To protect ourselves, we began buying gold in 2000. So far... so good.

And more thoughts... more rambles... more late-summer perambulations...

*** "Gold hasn't done too well lately, maybe it's time to get out..." The thought comes up from time to time, most recently from a visitor from Maryland.

"If the world economy is slowing down, commodities aren't the place to be..." he went on. "Gold either. People buy gold to protect themselves from inflation. But inflation isn't going to increase in a recession. You'd be better off in cash until this thing turns around."

Our guest voiced what is probably the dominant opinion of the summer — that a worldwide slowdown means price increases will slow down too. Without the hot breath of the inflation hounds chasing it, gold will go back to sleep and the Fed can continue to rescue speculators from their mistakes.

That's why the US 10-year Treasury note yields all of 3.78%. Yes, investors know they will lose money if inflation remains above 4%. But that risk — they believe — is worth taking for the safety of the dollar and the full faith and credit of the US Federal Government. Besides, inflation is almost sure to go down.

This view may turn out to be right. But when we think of moving to cash we pose the question: what cash? And there's the problem. The planet's alpha cash is the dollar. And while the dollar may have some limited upside in a punk market (it's already gone up about 7% against the euro), the potential downside is enormous.

What if the bond market is wrong about inflation? What if the increase in Producer Prices — now running at nearly 10% — works its way into consumer prices? What if demand from the developing world doesn't slack off as expected? What if there is war? What if the US economy worsens... and the feds need to cut rates and offer further $100 billion bailouts? What if Asian, Arab and Russian creditors lose faith in the dollar and switch to euros?

Any of these things could be catastrophic for holders of US Treasury bonds. At 3.78% yields — it hardly seems worth the risk. Shorter-term Treasury bills barely pay anything at all.

So what cash do you hold? We choose gold because it is cash that no central bank manages. No one prints. No government backs. And no one ever threw away a gold coin.

*** Colleague Joel Bowman lives in Dubai. We wondered whether the place was the bubble we had heard, so we posed the question to him. His reply:

"My short stay here in Dubai has led me to believe that Dubai & Co. is a largely unsustainable enterprise.

"Dubai's lifestyle makes the average American look like a prudent, energy-conscious, environmentally-friendly health nut! I read the other day that 60% of the average Emirates' total income is spent on consumer goods — Gucci totes, designer abayas and million-dollar number plates.

"The big difference I can see is that, save for the last few years, the vast majority of America's wealth accumulated over time and from the productive, honest toil of citizens who forged metal, cracked bullwhips and invented light bulbs. Dubai's wealth has come on fast and strong... and is not really the product of its own honest toil. Were it not for American, British and French companies — among others — who told them what all that black stuff underfoot was and what the rest of the world was prepared to pay for it, Dubai might still be a pearl diving port of a few thousand itinerant workers.

"If the American economy is drunk on its own home brew of "irrational exuberance," Dubai is sucking down straight tequila shots and desperately trying to catch up. We see it here everyday as the government squanders its unearned wealth on extravagant welfare programs and "National Identify Preservation" boards and committees dedicated to "cultural heritage association this" and "watchdog for immoral behaviour that."

Then there's the over-reaching controls on the economy — price fixing, wage manipulation, rent caps...the list goes on.

"I read with interest the "Frapp On Ice" story just the other day — about how Starbucks will close 600 stores over the next year as discretionary consumer spending shrinks. That story was all the more amusing for me as I actually read it on my laptop... in the Starbucks that just opened in the lobby of my building last week. There are now six Starbucks within walking distance from my front door (and I don't walk far — it was 125 degrees on Monday). We also have numerous Seattle's Best, Krispy Kreme's and the rest of the strip mall junk to go along with them. It's like anytown USA... super-supersized. Which brings me to my next point...

"Jumeirah Beach Residence (or JBR for the cool kids) is a 36-building project that opened a year or so ago. Each building is around 40 stories and there is said to be space for 25,000 people to live here. But where are the people, I ask myself? So few apartments are occupied that I still notice when a conspicuous new light comes on at night in the surrounding buildings... yet, apparently, most are sold. I can't see the newbies rushing to cut more keys as rent prices have, get this, risen by over 50% since we moved in in December. We took a relatively comfortable two-bedroom with a decent view, but if I walked in off the street today I couldn't get a studio on the first floor for the same price.

"The story is similar elsewhere in the city too. Projects are developed, pumped through the massive Dubai & Co. media arm and, voila! the joint is 50, 60, or 70% taken! "It's another success story," ring the papers. "Dubai's world-beating ingenuity triumphs again!" chorus the king and his merry band of sycophants.

But, best as I can make out, the biggest developments — including JBR, touted as the "largest single-phase residential project in the world" — are still ghost towns.

"A friend of mine was out the other day to inspect a house he saw for sale in one of these new developments (Arabian Ranches, in this case). The price was at the top-end of his budget and he was "umming and ahhing" about it until the estate agent casually threw in, "now, this property is only available in lots of 10." In other words, the development is being sold off in 10-house chunks to middle-men who then flip 'em and burn onto the next "world beating" development.

"So who's buying all these vacant houses, streets and islands? Some — and not just the conspiracy theorists either — say Dubai is a massive funnel for dirty Russian money. Others, including myself, reckon speculators buy into the hype... hoping a bigger idiot will buy into it a year later and hand them a handsome return.

"The trouble is, sooner or later you're going to run out of idiots. Even here in Dububble the supply of them is not without limit."

*** "What a project!"

Yesterday, we drove down oak-lined lanes to a tiny village on the side of a hill. A friend, Guillaume, inherited a castle and was showing it to the "Friends of Old Houses" group. We thought we'd have a look.

The place was built of granite over many centuries. Guillaume's grandmother lived there until she died in 2000. Her bedroom is about the only room in the house that is still liveable. Otherwise, it is a ruin. Leaks in the roof destroyed beams and rafters. Thieves stole furniture and paintings. Walls — even ancient stone walls — cracked and crumbled. We stepped carefully — watching out for the holes in the floor.

"This house has been in my family since 1217, when the Count de Cordon built it or bought it. He was my great-great etc grandfather. Of course, I can't let it fall into ruins. It's the family chateau."

Guillaume is a gendarme during the workweek. On weekends, he is a mason, a painter, or a carpenter. He has about 100 years' worth of repairs to make —

including installing electricity and plumbing.

Recently, Guillaume has been sent on 6-week tours to French Guiana, in South America, where his mission is to stop illegal gold mining.

"It's all jungle. A miserable place. I can see why we used to send prisoners there. Who else would want to go?

"These miners sneak across the border with Brazil. They're almost all Brazilian. But they're very industrious. They will carry pieces of a bulldozer with them — on their backs, because there are no roads. And they'll but them together. Then, by hand... or with these smuggled machines... they just dig up the earth, looking for gold.

"We're sent out in teams of 5 to 10... we parachute down to the jungle clearings... then we run them off. Usually, they take off when they see us. Then, we set fire to everything. We destroy their shacks and their machines.

"You wouldn't believe the kind of mess they make. Hundreds of acres can be torn up in a few weeks... and then, they wash all dirt down the river.

"Our problem is that once we get on the ground, we have to travel by foot... and sleep in hammocks, just like the local Indians. And the mosquitoes bite the hell out of us. But you get used to it..."

Back in France, Guillaume returns to the family chateau and gets back to work.