The Gold Standard Institute

The Metastasis of Moral Hazard and its Effect on Gold

By Stewart Dougherty

To those who study the numbers, it is now obvious that America's fiscal situation is hopeless. Given the country's current debt and unfunded liabilities of $75,000,000,000,000, an amount growing by at least $5,000,000,000,000 per year, it will be statistically impossible for the United States to pay its obligations unless it repudiates them in large measure, or the dollar is sacrificed on the altar of searing, society-altering inflation.

Congress and much of the nation are in utter denial about the country's unfolding fiscal catastrophe, as evidenced by federal spending that is actually accelerating, producing all-time debt and deficit records that exceed anything ever experienced by any nation on earth, at any time in history.

Denial is a psychotropic, mind-altering drug that by comparison makes crack cocaine look like health food, and addiction to it shuts down the brain. America's denial about its out-of-control spending, non-repayable debt, financial sector fraud and deceit, decadent political institutions, epic dereliction of leadership duty, fiscal and monetary immorality, and disastrously dishonest system of cronyism is leading the nation into an economic nuclear winter of desolation and chaos. Aside from Ron Paul, there is not one politician telling the people the truth about their oncoming debt enslavement and impoverishment; nor is there even one sign of constructive fiscal change on the horizon. Our visionless, gutless and greed-stricken leaders have transformed the United States into a cowardly new world.

But these facts are already well-known to the markets. In investing, the unexpected events change the game, causing significant price adjustments, either up or down. Wars, terrorist events, deaths of influential figures, natural disasters, provocations by foreign foes, paradigm shifts, innovations and the opening of commercial, geographic or intellectual frontiers have all, at their appointed times, had meaningful effects on markets. Successful investors need to keep their eyes focused toward the sun, because it is from its bright light that the jet fighters of change appear. Change wants to take us by surprise, and down to the ground. It is a contact sport.

Many are now making the assumption that because the country has been able to sustain surrealistically deplorable fiscal numbers for the past twenty years or more, it will be able to sustain them in coming years, too. Elected officials delude themselves into thinking that they have time to tidy up their affairs before announcing that they will not seek re-election so they can "spend quality time with the family," and assume they can get out of Washington before the machine flies apart. They expect to collect rich, self-legislated, taxpayer-funded, cost-of-living-adjusted government pensions plus free health care for life, while basking in the glory of such salutations as, "The Honorable," or "His Excellency." The odds are growing that things won't work out this way, as America burns through its borrowed time with a blowtorch. The question is, what is coming that will change the game and accelerate the arrival of the inevitable?

Continued on the following page

Inferential analysis is now saying that a game-changing trend having the potential to significantly affect America's institutions, economy and society might be well underway. Inferential analysis is the practice of identifying trends from seemingly unrelated events, and projecting their likely effects on the future. It can be highly predictive, and serves as an early warning system.

In this article, we will examine three contradictions that we think tell a much larger story in combination than each tells by itself. We will then examine the implications of these contradictions on the markets, and in particular upon the market for gold.

CONTRADICTION #1: On February 6, 2009, as it was becoming clear that the $700 billion TARP bailout had failed to achieve any of its promised objectives and as the mood of the citizens was darkening ominously as a result, Pennsylvania Congressman Paul Kanjorski (D), Chairman of the House Financial Services Subcommittee on Capital Markets, was interviewed on C-SPAN.

During that interview, Kanjorski attempted to make the case that the frantic, due diligence-free passage of TARP was necessary because Treasury Secretary Paulson and Federal Reserve Chairman Bernanke had told him and other, select members of Congress that the country was facing an historic banking crisis. Here is what he said, transcribed verbatim:

"On Thursday [September 11, 2008], at about eleven in the morning, the Federal Reserve noticed a tremendous drawdown of, ah, ah, ah, money market accounts in the United States, to the tune of five hundred fifty billion dollars was being drawn out in a matter of an hour or two. The Treasury opened its, ah, ah, ah, window, to help. It pumped one hundred five billion dollars into the system, and quickly realized they could not stem the tide. We were having an electronic run on the banks! They decided to close that operation, close down the money accounts, and announce a guarantee of two hundred fifty thousand per account so there wouldn't be further panic out there. [He was referring to the FDIC insurance coverage limit increase.] That's what actually happened. If they had not done that, their estimation was that by two o'clock that afternoon, five and one half trillion dollars would have been drawn out of the money market system of the United States. It would have collapsed the entire economy of the United States and, within twenty-four hours, the world economy would have collapsed. Now we talked at that time about what would happen if that happened. It would have been the end of our economic system and our political system as we know it. And that's why when they [the Treasury and Fed] made the point that we've got to act and do things quickly, we did."

Kanjorski's interview was broadcast worldwide and viewed by millions. It was also printed in newspapers in virtually every country on earth. It was regarded as a stunning, uncharacteristically honest admission for a politician, and was accepted at face value.

At the time, Congress was desperate to convince the citizens that the passage of TARP had not been a bailout, orchestrated by a Wall Street centimillionaire to the express and enormous benefit of a cabal of Wall Street millionaires and billionaires, but rather an heroic act that prevented the collapse of the United States and the world. Washington had to somehow explain why average citizens were being forced to pay for Wall Street's losses, when during the previous decade, Wall Street had kept every dollar of its trillion dollar profits for itself. Now, as Washington and Wall Street were shoving those losses down America's throat without a popular vote, or even a serious debate, they were grasping for straws.

But there is a problem: Kanjorski's story makes absolutely no sense whatsoever. He said that $5.5 trillion would have been withdrawn from money market accounts on September 11, 2008, but according to the FDIC, the total amount held in bank money market accounts at that time was only $2.9 trillion. (The grand total of all FDIC bank deposits then, including everything from checking accounts to CDs was $9 trillion.)

Continued on the following page

In addition to bank money market accounts (to which Kanjorski apparently referred, and as Chairman of the House Subcommittee on Capital Markets, he should certainly have been familiar with basic banking terms), there also exist "money market mutual funds," operated by mutual fund companies. Total deposits in those accounts were only $2.3 trillion at the time, for a grand total of $5.2 trillion in both money market categories.

Kanjorski's claim was that 106% of all bank and mutual fund money market deposits were going to be withdrawn between the hours of 11 AM and 2 PM on September 11, 2008. In other words, every single money market depositor was going to sell every dollar of their holdings during those three hours that day, plus another 6% out of nowhere. Of course, that would have been impossible.

While the numbers themselves prove the invalidity of the story, there are other aspects to it that make no sense, either. Kanjorski said it was "an electronic run on the banks." But to where? If the transfers were electronic, then by definition, they were staying within the United States banking system. The notion that every single money market account holder also had a foreign bank account to which they planned to transfer the money is factually incorrect, and absurd.

Every true bank run in history has involved people going to their banks and demanding cash, not electronically transferring their funds from one bank account to another. In a true bank run, depositors want cash because they fear their bank will fail, taking their money with it. As we know, there was not one REAL bank run on September 11, 2008, involving depositors lining up at banks and demanding cash that could not be provided because banks had run out of it.

The story was a hoax, either concocted by Paulson and Bernanke to frighten Congress into passing TARP without due deliberation and then repeated by Kanjorski, or concocted by Kanjorski to make him and Congress look like heroes for spending $700 billion of taxpayer money on a desperately flawed bailout that was, at best, an egregiously negligent misallocation of public money, and at worst, the biggest outright taxpayer theft in history. His interview presents a classic case of propaganda and brainwashing, of which even Orwell would be proud.

CONTRADICTION #2: For more than twenty years, representatives of the United States government did nothing as millions of manufacturing, information technology, software development, customer service and other jobs were exported to foreign countries. In fact, government actions, such as: NAFTA; direct and indirect currency manipulations that artificially supported the U.S. dollar, negatively affecting exports and opening the floodgates to a cascade of imports; lobbyist-promoted, knee-jerk political support for a fuzzy, untested concept called "globalization;" and a government culture oblivious to or strangely supportive of America's employment crisis, all expressly intensified the country's job losses. The export of American jobs resulted in chronic, multi-hundred billion dollar annual trade deficits, compounding the country's financial distress. It was as if a secret deal had been entered into between the United States government and select foreign trading partners: You buy our bonds, and we will send you our jobs.

Apparently, no one in government could have cared less that the lives of millions of American families were shattered as their jobs vanished and their finances crashed, or that the country had become crippled as it lost its manufacturing base and morphed into a so-called "service economy," an economic fantasy that is now failing catastrophically. Perhaps there would have been greater concern in Washington if government jobs were being exported to foreign countries, too.

Contrast that to the following: within mere weeks of the Wall Street financial crisis going Code Blue in late 2008 (thanks to Wall Street's own Biblically-epic avarice and recklessness), Congress had passed the largest financial industry bailout package in the country's history, based on nothing more than a few "back of the envelope" proposals made by a seriously-conflicted Goldman Sachs executive turned Treasury Secretary and a cooperative head of the Federal Reserve. This was despite the fact that 90% of the American people were instantly and adamantly opposed to TARP, proving that they

Continued on the following page

are not nearly as stupid as Washington and Wall Street like to think they are. After Wall Street learned how easy it was to obtain $700 billion from the citizens, the floodgates were opened wide and trillions more flooded into their money caverns. Year after year, despite their well-known unemployment misery and its enormous cost to the country, American workers got nothing; Wall Street was given trillions in a matter of weeks just for squealing like stuck pigs, and using their political juice.

To the people's credit, we are now learning that the TARP funds were badly misspent, with the government having significantly overpaid for the toxic assets it purchased from crony banks. Nobel Prize winning economist Joseph Stiglitz recently observed that the overpayments were 50% at a minimum, and in many cases much more. This resulted in tens of billions of dollars of additional illicit profits flowing to Wall Street at the expense of the citizens. The people were correct: TARP was a fraud that never should have happened.

CONTRADICTION #3: After becoming the nation's top auditor in 1998 as Comptroller General of the United States and head of the Government Accountability Office, David Walker repeatedly warned Congress over a period of several years that government spending was unsustainable, and that unless fiscal policies were reformed, a monetary and economic disaster would ensue. Walker presented irrefutable evidence to Congress to support his warning, evidence so powerful it was never contested because it could not have been. Walker focused Congress's attention on spiraling, deca-trillion dollar Medicare, Social Security, prescription drug, military and government pension, welfare, trade and general obligation deficits and liabilities, in addition to the crippling impact of ever-increasing interest payments on the rapidly increasing debt.

Instead of heeding Walker's flawlessly-reasoned warnings, Congress did the exact opposite and went on a spending binge never before seen in American or world history. Just one program, the Medicare Prescription Drug Plan was bankrupt on Day 1, with an unfunded liability of $7,100,000,000,000 that was heaped on top of taxpayers' existing, crushing debt burden. That turned out to be just the warm-up act. It was followed by an unprecedented fiscal year 2009 federal deficit of $1,600,000,000,000+, which will then segue into 70 years' worth of multi-hundred billion to trillion dollar plus deficits. Furthermore, the government approved $13,000,000,000,000+ in bailouts for favored insiders. Every penny spent on these programs represents newly created debt, on which interest will accrue in perpetuity since the principal can never be paid.

There are additional, related contradictions, such as presidential candidate Obama promising "change you can believe in," and then, once elected, installing into positions of economic power and influence people such as Lawrence Summers and Timothy Geithner, who had been directly involved with the policies and programs responsible for the crisis in the first place. Obama subsequently proposed that the Federal Reserve be given vast new powers over the financial system. This was astonishing, given that the Fed, under Chairman Greenspan and successor Bernanke was clearly implicated in the meltdown, though not alone in culpability.

The fundamental common denominator in each of these contradictions is immorality. Creating money out of thin air is counterfeiting and theft, no matter who does it. Bonds that can never be paid are promises that cannot be kept, and are dishonest. Lying to the people for self-glorification, and to divert attention away from actions that were negligent and destructive is immoral. A government that robs from the poor and gives to the rich is corrupt. A government that casually throws its workers to the wolves while toadying to the wealthy is morally lost. And a Congress that decides, in direct rejection of the United States Constitution, that there will be two classes of citizens in America, the commoners and the elite, the serfs and the nobles, is derelict in its duty and a disgrace to its high office.

Continued on the following page

Contemporary society is an amusement park of addictions. Most emphasis is given to the substance addictions, such as to nicotine, food, alcohol, or drugs. Less attention is given to the activity addictions, such as to shopping, gambling, television and sports, habits less physically dangerous and depleting, but life-affecting for those who become consumed by them.

Two other addictions get far less attention than they deserve, given the powerful forces they have exerted on humanity throughout history. Those addictions are to money and power. Washington is about the addiction to power; Wall Street is about the addiction to money. Those two centers of addiction are now galvanizing each other. By finding artificial means by which to temporarily keep the government's sinking financial ship afloat, Wall Street supports Washington's power addiction. By funneling trillions of public dollars to Wall Street, Washington supports the bankers' money addiction.

These twin addictions to money and power represent another piece of the moral hazard puzzle. Addiction breeds immorality. Addicts will stop at nothing to get their drug of choice.

The colossal miscalculation made by Washington and Wall Street is that they could control the moral hazard genie once they removed it from the bottle. They believed they could use the genie to enrich themselves with trillions of dollars' worth of taxpayer money, and then replace it in the bottle before its magic spell of immorality metastasized throughout society at large. They assumed that the people would be too stupid to see what was going on. And that even if the people did figure things out, they would willingly wear the thick, choking chains of debt being welded to their necks by the financial elite and its Washington enablers.

Instead, thanks to the Internet and the democracy of information and insight it affords, the people were instantly wise to what was happening, and it stirred them. The concept of "an eye for an eye, a tooth for a tooth," harkens to the Bible. [1] And perhaps Shylock was speaking for all of humanity when he said, "If you prick us, do we not bleed? If you tickle us, do we not laugh? If you poison us, do we not die? If you wrong us, shall we not revenge?" [2]

There is accumulating evidence that the Washington - Wall Street moral hazard experiment has gone disastrously wrong, and that just like any other accidental discharge of a deadly virus, the moral hazard virus is now loose and swiftly propagating throughout society. By so blatantly colluding with Wall Street, Washington has lost all moral authority, and the people now have only one place to turn: themselves. An ethic of, "If they can do it, so can I," is spreading, as people realize that fabric of American society has been shredded and replaced by a free-for-all mentality whereby everyone must fend for oneself in order to survive.

If this is so, it is a serious game changer for America.

Evidence of the spread of moral hazard is noticeable everywhere. Despite government reports that the economy contracted only 1% last quarter and is now stabilizing, 13% of all home mortgages were either delinquent or in foreclosure in the second quarter, 2009, an all-time record. Credit card write-offs hover near 10%, also a record. Automobile, home equity and personal loan defaults are at or near record levels. Fiscal year 2009 federal personal tax receipts have declined 22% and corporate receipts have plunged by 57%, even though the economy has supposedly declined by only a fraction of that amount. Compared with January through April, 2008, state personal income tax receipts have plummeted by 26% in 2009, with eight states seeing declines ranging from 30% to 54.9%. Prime and Alt-A mortgage delinquencies and foreclosures are climbing rapidly, and are the true canaries in the banking industry mineshaft. Homeowners evicted by foreclosure trash their homes in rage on the way out the door, with an estimated 50% of such dwellings damaged. Looters and squatters destroy many of the rest, stealing copper pipes, wiring, granite counter tops and anything else of value. Dozens of Internet sites such as "youwalkaway.com" provide calculators to help homeowners decide whether or

Continued on the following page

not to "strategically" default on their mortgages. Shoplifting costs retail businesses $35+ million per day, as 27 million shoplifters go on the hunt. Drug addicts who have become shoplifters say that the activity is equally as addicting as drugs, leading to a continuing cycle of theft. [3] Insurance fraud is a systemic financial risk, with 25% of fires caused by arson or suspected arson, making this the greatest cause of property damage in the United States. Even before this financial crisis, which has bankrupted millions, 10% of respondents said it was acceptable to submit a false insurance claims.[4] Medicare fraud exceeds $60 billion per year. Phony automobile and other bodily injury claims cost billions annually, and are difficult to control since it is impossible for a court to tell someone they are not in pain. Despite a massive consumer education campaign designed to thwart it, Identity Theft rose 22% in 2008, to 10 million cases, a record. It takes the average victim 330 hours to repair the damage to their personal reputation. [5] Identity Theft is estimated to cost individuals and businesses $221 billion per year. [6] Each day, 175,000 phony checks are presented as payment. The cost of check fraud is estimated to exceed $50 billion annually. And on and on it goes.

The stress tests never envisioned this.

The people, whose predictive instincts have been uncannily accurate throughout this crisis, sense that trouble is coming: 80% of them say they expect crime to increase due to the deteriorating economy. [7]

As average American citizens lose their jobs by the millions, become mired in financial distress and are crushed by the largest debt increase in the history of civilization to pay for government bailouts and fiscal stimulus programs, several Wall Street firms, in actions so arrogant they beggar and defy belief, have announced that they will pay record bonuses in 2009. These bonuses commonly amount to 20 - 200+ times the median American wage, in other words, 20 - 200+ times the earnings of the citizens whose taxes were spent only a few months ago to keep the Wall Street firms from imploding.

Nurses, police officers, school teachers, store clerks, truck drivers, gas station attendants, firemen, flight attendants, ambulance drivers and everyday workers of every other description, many of them struggling to provide only a humble, basic lifestyle for themselves and their families, were asked to reach deep into their pockets to help Wall Street survive. Now that Wall Street has taken their money, it will use it to lavish huge bonuses upon itself, in a callous Roman orgy of excess.

The American psychological landscape has been parched by the searing winds of financial desperation, surging inequality and dying hopes. And the tinder of the desiccated American Dream, once the great calling and aspiration of a nation, is now piled so high that a spark igniting it would unleash raging flames reaching up to and scorching an astonished Sun. Yet politicians and the press are so divorced from reality that when the people express at town meetings and other venues their deep, legitimate frustration over the loss of their hopes and nation, they are viewed as whiners, or paid political activists. As noted earlier, denial is very dangerous drug.

Civilized society requires a foundation of morality, decency and justice to survive. The spread of moral hazard, should it happen, will have a disastrous effect on America's institutions. Few investment classes will be safe in an environment of elevated moral hazard, because both legal and illegal counterparty risk will surge. Legal counterparty risk occurs when, for instance, a corporate executive at a public company is awarded excessive, unwarranted pay at shareholder expense. (Abercrombie and Fitch recently reported that its CEO was paid $70 million this year, as the company's performance deteriorated and the stock price plunged by 70%. This is an example of legal counterparty risk. It is a disgrace.) Illegal counterparty risk occurs when there is fraud. (Enron and Madoff are just two of many possible examples.)

In the emerging social climate, common stocks will face powerful headwinds from a suffering economy made worse by the corrosive costs of theft, fraud, false executive enrichment, phony

Continued on the following page

insurance claims and frivolous lawsuits. Bank deposits, yielding near-zero percent interest rates, are basically no better than cash in mattresses. Corporate bonds carry serious interest payment and default risks. State, county and municipal bonds will become increasingly stressed as deficits grow and proposed tax increases stoke voter anger, making it difficult to close funding gaps. The real estate sector faces a spike in taxation risk, due to deteriorating local and county government finances. It is also subject to interest rate risk, as surging government debt becomes difficult to sell, resulting in higher coupons. The reputations of hedge and private equity funds have been compromised by large losses, the imposition of redemption restrictions, and high fee structures. Algorithmic, black box trading has been largely discredited. Annuities carry heavy fees and important counterparty exposure, as seen by the industry's bailout by government. Commodities prices are volatile, and price manipulations by large traders are legion. CFTC oversight is lax to non-existent, so small investors are without protection. While there are many good commodities funds, they carry counterparty risk. Derivatives markets are opaque and out of control, in addition to being nuclear waste sites of counterparty risk, and are certainly no place for individual investors. Art, diamonds, numismatics, collectibles and other highly specialized asset classes have large transaction costs and are best suited to experts. As we can see, investment safety is hard to find even in normal times, which these are not.

In the recent crisis, virtually every investment "truism" has been discredited as a myth. Buy and hold; Stocks for the long term; Efficient market theory; Housing prices only go up; Buy land, they're not making any more of it; Municipal bonds offer safe, tax advantaged returns; Treasurys are guaranteed by the full faith and credit of the United States; the dollar will remain strong because it is the world's reserve currency; A diversified portfolio offers protection; Demand for serious art works is unquenchable; and on and on. The current markets have laid waste to every one of those theories, and many others.

Gold is the antithesis of the investment classes described above. Physical gold represents pure wealth of a very finite quantity with absolutely zero counterparty risk. Because of this distinguishing fact, it is immune to the costly effects of moral hazard. Gold does not have expensive skyscrapers named to stroke its ego, nor does it have offices or branches dotting the land. Gold has no CEO who demands a multi-million dollar compensation package just for showing up. It has no employees desiring pay raises, health insurance or vacations. Gold does not take three hour lunches, play golf, drink martinis, do drugs, get sick, or demand a lavish expense account. Gold is not dependent upon protection from regulators who discover frauds only after every innocent investor has been wiped out. Gold is not represented by a Congress that spends it into bankruptcy. Gold is unaffected by the Devil's songs of greed and graft sung by lobbyists and other self-serving parasites. Gold does not charge an endless procession of monthly or annual fees. Gold cannot be manufactured out of thin air by politicians or Central Bank monetary witch doctors.

As money, gold has not one legitimate competitor, though it is surrounded by fiat fakes. In time, those frauds always die of their chronic, congenital disease: immorality. Gold is the free and honest money of the people, not the controlled, monopoly money of bankers intent upon destroying it for private gain by debasement and inflation. Having been born at the beginning of civilization, it possesses the wisdom of time. It is liberty. When border crossings have been closed by soldiers with machine guns and paper money has been a useless persuader, gold has opened the gates for refugees fleeing tyranny and oppression, providing them safe passage. With beauty commensurate to what it represents, gold makes tangible the wondrous, invisible force of freedom. In Latin, the word for gold is aurum, meaning "shining dawn." Gold is more than honest money; more, even, than liberty. It represents the endlessly renewing fountain of the future, and the shining dawn of life.

As the existing system destroys itself, the question becomes, "how will wealth and financial freedom be defined in the future?" Today, we say that dollar millionaires and billionaires are wealthy. They

Continued on the following page

used to say that about those who possessed millions or billions of Zimbabwean dollars. But that fiat currency is now dead and its possessors are penniless. History is absolutely categorical: fiat currencies are immoral, and because of that, they fail, without exception. Repeat: without exception, as documented throughout all of time. The new wealth will be measured in something different, most likely gold. There are only 5 billion ounces of it on earth, or roughly 0.75 ounces per capita. The supply grows at less than 2% per year, a fraction of world fiat money growth. Much of it is not and will not be for sale; the amount available to the market is less than 0.25 ounces per person. As gold takes its rightful place of honor as the people's reserve currency, demand for its limited supply will continue to grow. Tomorrow's billionaires will be those who prepare today for the coming, inevitable monetary paradigm shift. Those who acquire gold now, while it is still available and inexpensive, will create for themselves a future that is secure, free and rich with opportunity.

Stewart Dougherty is a specialist in inferential analysis, the practice of identifying patterns and trends in specific, contemporary events and then determining their likely effects upon the future. Dougherty was educated at Tufts University (B.A.), and Harvard Business School (M.B.A. and an academic Fellow). He can be reached at *trident888@cs.com*. He is not affiliated with or compensated by those he references or recommends. He does not offer investment or trading advice, and nothing in this article should be construed as such. This article represents the author's personal opinions, and nothing more.

Footnotes:

[1]: The Holy Bible: *Exodus - Numbers; 21: 24*; [2]: William Shakespeare; "*The Merchant of Venice;"* III, i, 65; [3]: National Association for Shoplifting Prevention, www.shopliftingprevention.org; [4]: www.insurancefraud.org; [5]: Javelin Research and Strategy; [6]: The Aberdeen Group; [7]: Rasmussen survey dated August 18, 2009.