

# FORUM HALL OF FAME

**GOLD & MONEY: More Than Meets the Eye**

**Aristotle's Commentary**



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## **GOLD & MONEY: More Than Meets the Eye**

Thanks in advance to Aragorn III for his direct input and valuable insights for what I am embarking on here. Much of this I hope will help to illuminate many of the developments and ideas that have been valiantly offered by ANOTHER and FOA over many preceding months.

### **Part 1 --- Stormclouds Gather...**

The estimable economist Milton Friedman stated his forgettable opinion in 1974 that OPEC would collapse and oil would never get up to \$10 per barrel. In all fairness to Professor Friedman, we must recognize his position as coming from a staunch monetarist, emphasizing money supply as the "true religion" for the Federal Reserve to keep the US Dollar as good as Gold. At times, he half-seriously argued for the abolition of the Federal Reserve in light of the simple monetary policy guidelines that could serve in its stead, with the economy returning to a state of self-regulation. (In the past sound-money days, economic hardships were far from unnatural, and they were not necessarily attributable to acts of government. However, modern attempts to centrally manage the economy ensures that any blame for systemic difficulties today may be clearly laid at government's feet.)

Milton's mistake was two-fold. First was his knowledge that Arabian oil could be produced for one dime of real money, and that inevitable competition among OPEC members would surely keep the price close to cost of production. Second, and most importantly, Milton failed to account for the possibility that the government would abandon such reasonable monetary management to keep the dollar nearly as good as Gold. **This fact was NOT lost, however, on the oil producing countries. Ask yourself, what would YOU do if your business or trading partners suddenly started offering you payment with Monopoly money instead of "real" money?** Would you shun real money as though it were the plague, and embrace Monopoly money as the greatest thing since sliced bread? If you would, then I have got a job for you!! Bring your shovel and some work-clothes, you have been hired for life...

**Upon the 1971 declaration by the United States that redemption of dollars for Gold would be terminated, the entities in receipt of dollars for balance of trade settlements had no difficulty recognizing this as an outright default on payment contracts.** The scramble was on to make sense of this new payment system in which the dollar was no longer a THING of value (a small amount of Gold), but was now reduced to a CONCEPT of value; an undefined unit with which the world would denominate the amount of value in contracts for goods and services. The problem ever since has been in coming to terms with the meaning of value for this shifting and undefined unit, and its vulnerability for mismanagement and abuse.

Jelle Zijlstra, who became head of the Bank for International Settlements, said while with the Bank of the Netherlands in regard to the 1971 severing of Gold from the dollar, "When we left the pound, we could go to the dollar. But where could we go from the dollar? To the moon?"

As I continue this tale, I hope it becomes clear that not only have we gone to the moon, but that Gold is going there also.

## **Part 2 --- A Transition: Things Are what they Are...**

Do you see the world as *it is*? Or, do you see the world as *you are*? A tough obstacle, to be sure, as our experiences weigh heavily on our perceptions, and many people have no practical earthly experience with real money. There is hope..."the Truth is out there!" as a popular show is quick to proclaim. Albert Einstein puts an interesting slant on this theme: "My religion consists of a humble admiration of the illimitable superior spirit who reveals himself in the slight details we are able to perceive with our frail and feeble mind."

So with a ready admission our minds are frail and feeble, let's prepare to tackle something so ponderous it must hopelessly remain an abstraction to us mere mortals. I refer to the U.S. national debt, expressed in dollars, that stands at 5.6 trillion. Wow! What does that really mean? To put it in some perspective, we will revisit the 1970's, and try to get our arms (and feeble minds) around some much smaller numbers, and yet numbers that themselves are large enough to be abstractions. Let's examine the incredible and overwhelming wealth and economics of oil.

Imagine having claim to a sandy and barren land that reaches 120 degrees Fahrenheit in Summer, making your living through the ages on goats, dates and Pilgrims to Mecca. Not a posh existence when compared to America in the Roaring 1920's, but the passage of time reveals the fortunate few that were in the right place at the right time. When the Standard Oil Company of California was granted an exploration concession for Saudi Arabia in 1928, the 35,000 Gold sovereigns paid by Social were reportedly counted by Sheik Abdullah Sulaiman himself. Wispy shades of things to come! This can be thought of similarly to how you might view a collection of skinny stock investors who found themselves heavily invested in penny internet stocks when the technology market exploded in the 1990, making them all millionaires. Except this: Oil is much, much bigger! We will soon examine what it means to be in the right place at the right time.

I will talk about pricing and balance of trade in the next part...stay tuned for the biggest transfer of wealth the world has ever seen. The key-currency gets debased in 1971, and Gresham's Law rules the land.

### Part 3 --- It's Only (a mountain of) "Money"...

Having purchased this Saudi Arabian concession, in subsequent drilling Socal's Damman Number 7 struck oil in 1937 (I believe old Number Seven is still flowing.) Socal partnered with Exxon, Mobil, and Texaco to form the Arabian-American Oil Company. Over a thirty year period, Aramco discovered petroleum reserves in Saudi Arabia in excess of 180 billion barrels...a quarter of the known reserves of the planet at that time. And as the world aged and changed, the amount of oil consumed daily in world trade climbed dramatically, from 3.7 million barrels per day in 1950, to 9.0 mbpd in 1960, to 25.6 mbpd in 1970, to 34.2 million barrels per day in 1973 during the first Oil Crisis.

Consider this for better perspective: the average yield per well at the end of the 70's in the United States was 17 barrels per day per well, in Venezuela (one of the co-founders of OPEC) it was 186 barrels per day per well, and in Saudi Arabia (the other OPEC co-founder) it was 12,405 barrels each day per well. Wow! Just imagine if the internet companies today issued new, additional shares each day at this same rate as oil consumption...the stock price would plummet! **But unlike internet stocks, because this oil is consumed, it must be replaced (and paid for) every single day.**

But before I can move into the fascinating region of this miniseries that sheds light on how and why the Gold market is as it is today, this background is vital, so please bear with me, and I shall thank you for your patience. Oftentimes, understanding is its own reward, but in this case it may well prove essential for wealth preservation at a minimum. To begin, we must look at life in these United States (and in the process we will see a compelling reason that import barriers must be fought tooth and nail)...

What does the Texas Railroad Commission have to do with this story? Plenty. So much oil was being produced in Texas in the 1930's that engineers were concerned about depletion and wastage, and the owners would fret over the effects of oversupply that would at times bring the price per barrel down to ten cents. Tiny independent producers were often drilling side by side with the majors, but when the price slumped their profitability suffered more because they didn't have income from the downstream processes like the majors did. Because some of the individuals operating these independent companies happened to be multimillionaires, their complaining voices were heard thanks to their political contributions.

**The state government responded by giving the Texas Railroad commission the power to regulate drilling.** And while they didn't have the authority to set prices, **they could regulate production levels.** By setting an appropriate rate of production, oil would be conserved and this restricted supply would achieve price levels high enough to keep the independents in gravy. This Texas price became the American price, and also the world price (in the 1950's the U.S. was producing half of the world's oil.) This meant pure profit for the major companies with overseas production that cost only ten cents per barrel. To keep the price of oil up, what started as a gentlemen's agreement among the American oil companies to limit the imports of cheaper oil later became enforced by the U.S. government--known as the "invisible dike" against the outside world of cheap oil. Throughout the 1960's, the Persian Gulf offered the world oil at \$1.80, while inside the "invisible dike" oil was being sold to the nation at the Texas price of \$3.45 per barrel by the end of the decade.

The great irony is that a Venezuelan lawyer (and oil minister) named Juan Pablo Perez Alfonso studied and used the Texas Railroad Commission as his model for OPEC, which he co-founded with the Saudi Arabian director of the Office of Petroleum Affairs, Abdullah Tariki, in 1960. OPEC from the beginning maintained that oil was a depleting asset, and it had to be replaced by other assets to balance national budgets and fund developments.

Now that we know a bit about the producers and the price and cost of oil during the era of "real money," let us take a look at the dollar itself. The dollar and the world was pegged to Gold via the post-WWII Bretton Woods agreement in which \$35 was convertible to one ounce--but for foreigners only,

not U.S. citizens. The rate for international currency exchange was coordinated through the International Monetary Fund (IMF), with each currency pegged to each other through the dollar and Gold. The U.S. economy steamed along nicely in the 1950's, producing half of the world's oil as I've already stated, and half of the cars that burned up this oil. By the arrival of the 1960's, American industry was buying foreign factories, equipment and raw materials. In addition, the government was spending for its foreign bases and troops, and Vietnam was funded largely in the red.

An overhang of dollars was developing overseas--and while at first the foreigners were reassured that the Gold guarantee of the dollar was solid, as ever more dollars piled up, ever more of them cashed in the dollars for Gold. General de Gaulle summed up the sentiment, saying that America had "an exorbitant privilege" in ownership of the key-currency. By that he meant that the dollars America was able to issue via simple printing carried the same value in trade as the dollars that had to be earned by other nations through meaningful productivity. It quickly became clear that too many claims had been issued on the limited Gold, and President Nixon was prompted to close the Gold exchange window in the face of a certain run on the Treasury.

In a quick repeat from Part 1: *"Upon the 1971 declaration by the United States that redemption of dollars for Gold would be terminated, the entities in receipt of dollars for balance of trade settlements had no difficulty recognizing this as an outright default on payment contracts. The scramble was on to make sense of this new payment system in which the dollar was no longer a THING of value (a small amount of Gold), but was now reduced to a CONCEPT of value; an undefined unit with which the world would denominate the amount of value in contracts for goods and services. The problem ever since has been in coming to terms with the meaning of value for this shifting and undefined unit, and its vulnerability for mismanagement and abuse."*

With OPEC in place, and the dollar now rendered meaningless by traditional standards, the stage is adequately set to describe what followed. With OPEC now united and able to conserve, and threaten to cut back in the grand tradition of the Texas Railroad Commission, they were able to name their terms of payment, and decide essentially what value the dollar would have in oil terms. That is important enough to repeat: **They were able to name their terms of payment, and decide essentially what value the dollar would have in oil terms.** The increased world demand for oil ensured that the price would be met (Texas was pumping around the clock and still coming up short), and the printing presses essentially ensured that there would be no lack of dollars, so to speak.

It is important here to realize the attitude of OPEC, and notably the Middle East. In the mid 1970's, the finance ministers of both Kuwait and Saudi Arabia stressed that their needs were only to provide for the welfare of their citizens, and that oil in the ground is better than paper money. Who from the West can argue with that? They called our money's bluff, fair and square. So in 1971, while the Texas price of oil was \$3.45, OPEC re-priced their Middle Eastern oil up from \$1.80 to \$2.20 (such audacity, don't you think?) only to see the market price due to demand in 1973 overtake the official posted price, at which point OPEC saw the writing on the wall, and in October raised the price per barrel to \$5.12 while curbing production. By December, the Shah of Iran called a press conference to announce the official price would now be \$11.65. Well, why not? It's only paper to you if you are not in NEED of this currency through a debt to someone else. And so began the First Oil Crisis of the 1970's.

Just as America had been issuing claim checks on the national Gold throughout the 1960's, its spending habits didn't change with the advent of the all-paper dollar. As a consequence, the world's greatest transfer of wealth was underway. Watching the rising cost of real estate became a national pastime in the 1970's--an odd distraction from the gas lines and cost of fuel. By raising the price of oil \$10, from \$1.80 to \$11.65, at those current production levels OPEC raised its annual revenues by approximately 100 billion dollars. Now recall from Part 2 where I promised you we would tackle some large numbers, though nowhere near as incomprehensible as the \$5.6 trillion U.S. debt. Here we go...

How much IS 100 billion dollars per year? It can't be much, because we all know the Middle East is heavily in debt with struggling economies even now at the end of the 1990's. Right? Well, I invite you to follow along, and judge for yourself. Let's try to spend that \$100 billion, and remember...it is 1974. And let's not waste time on small stuff, we'll go right for the big ticket toys.

How about some F-14's? Fully equipped (minus missiles because we are a peaceful bunch) they are ours for \$9 million each. Grumman on Long Island assembles 80 each year. Hell, let's take 'em all for \$720 million. How about some F-15's too? At \$12 million each, we conclude our visit to McDonnell Douglas with 100 under our arm for a cool \$1.2 billion. Let's take home the biggest brute the U.S. has to offer--a top of the line nuclear-powered aircraft carrier for \$1.4 billion. Better yet, make that two carriers. Throw in some destroyers, some submarines...let's see... We've spent a total of \$2 billion on a kicking air force and a little more than that on a fine little navy. How much money is left in round figures? About \$100 billion. And this amount comes in not only this year, but the next, and the next, and the next... [a side thanks to Mr. Goodman for these historical prices.] \$100 billion is a large annual paycheck, and we haven't even touched the \$30 and \$40 dollar prices brought about in the Second Oil Crisis. Now consider again that America has written future claims on \$5.6 trillion dollars. Can you imagine how such a figure might be settled? Ouch.

Where did all of this money come from? It would seem that America found an efficient means to issue claims on the country in exchange for something that goes up in smoke. Would OPEC own America lock, stock, and barrel? What would OPEC do with all of that cash? And would there be any end to it? How are the poorer countries that must EARN their dollars, as General de Gaulle indicated, going to fund their own oil needs? Banks are the answer. Buy banks, fill banks, and recycle the petrodollars. Oh, and let's not forget Gold. Straight from two ministers of finance, **"We would rather keep the oil than have the paper money."** We thank you for that insight.

Now that I have properly set the stage, in the next part I shall relate the really good stuff of Aragorn's tale suggesting where this money went, and how the system survived 20 years after the end was nigh, bringing cheap Gold crumbs for anyone mindful enough to pick them up. To quote that good knight, "With a payday reaching that magnitude, the question of destiny begs no answer. You set your own, and hope for nice weather."

#### Part 4 --- A 1970's History Lesson (without the disco)

One Oil Crisis down, one to go. We looked at some pretty incredible figures in Part 3. Where did this money go, and maybe more importantly, where does it come from? For the sake of brevity I will assume the reader is well acquainted with the process of money creation via modern banking. If not, then you have some important questions to ask and research to do. For now, accept on faith that new money is created (as a simple ledger entry at a bank) through the process of borrowing. A loan creates new money, and banks collectively may create money far in excess of what they hold on deposit. *As a contract, the loan is quite real, but the dollar is not. A dollar is an undefined concept--an undefined unit of measurement for value, so to speak. You can see how such an arrangement favors those in a position to name their price.*

As you can well imagine, for a country such as Saudi Arabia that had been subsisting on simple agriculture and the business of Pilgrims, a sudden infusion of such a magnitude of money can be seen as pure profit, and a fine opportunity for capital improvements to national infrastructure. Much of this money flowed back to the rest of the world to pay for international contractors and materials. But clearly, much more money was coming in than could possibly be spent. Vast sums of it found its way into the world's largest international banks--the five largest American, three largest Swiss, three biggest German, two biggest British, and then on to the next tier... Suddenly there were over one hundred banks that set up shop in tiny Bahrain: Citicorp, Chase Manhattan, Barclays, and Bank of Tokyo among them; all competing for surplus oil profit deposits. Paris suddenly found itself host to over 30 new Arab banks.

So much money flowed in, and so much was lent in turn to the poor countries that could scarcely afford to buy oil with their meager exports, that *the financial system became a large game of musical chairs, and the biggest risk was that the music might stop.* There were no chairs to sit on! To protect themselves from the unthinkable--that the Arabs might pull their deposits out of an individual bank--the banks developed a system. This system provided for the relatively smooth inter-lending of funds. Because even though a bank can create new money "out of thin air," they have to have deposits in the bank as a starting point. If these funds were to be withdrawn, the bank must locate other deposits to cover their outstanding loans. If the money were pulled, say from a British bank, it had to go somewhere; the amount of money was too great to "hide" for long. This British bank could call around, and arrange to borrow the funds back from a Swiss bank, or German bank, by paying a nominal interest rate on this inter-bank loan. The important concept to grasp here is this: as long as the petrodollars stayed in the banking system, the banking system would survive.

In fact, that is how the world weathered the storm of the First Oil Crisis. Such a grand scheme of inter-reliance was formalized by several central banks in a meeting in Switzerland to handle any event should money come up short in one area or another--the Basel Concordat. Have you ever heard of the LIBOR in any of your financial reading? Some credit card issuers make use of the LIBOR instead of the US. prime rate in their contracts. It is the London Inter-bank Offered Rate, and functions as the international bank borrowing rate, and it is the tie that binds the group together into a nearly seamless global financial System.

When the First Oil Crisis caused a global tightening of belts, only America, as the issuer of the key-currency, could shamelessly create new money with ease to pay its bills. Other countries had to balance their own books with productive output, or else turn to the banks to borrow the needed funds. And borrow they did! Let there be no doubt that these petrodollars were recycled through the banking system. Throughout the Oil Crisis and the distractions of the Nixon Watergate scandal, the former Secretary of Defense under the Johnson administration, and then president of the World Bank, Robert McNamara, was focused on one thing only--maintaining the good graces of OPEC. McNamara had to ensure continued access to OPEC's funds. During 1974, the World Bank had drawn on OPEC for \$2.2

billion, for a total at the time of \$3 billion--one quarter of all World Bank debt. For Euroland banks, business was booming because lending was their business. And the IMF had its hands full trying to hold together the international currency exchange system.

Some of the countries that quickly found themselves behind the eight-ball: Brazil, Korea, Yugoslavia, the Philippines, Thailand, Kenya. (You can easily imagine that there aren't enough coffee drinkers in Saudi Arabia to achieve a meaningful balance of trade of coffee beans for oil for a country like Kenya.) So in a move driven more by politics than banking to ease the financial squeeze upon a nation's citizens and industry, the governments would turn to their central banks and to the international and multinational banks to secure the needed money. **And the banks couldn't stop lending, because many countries relied on new loans to pay off the old loans in addition to their continued need for oil. Loans in default were simply rescheduled. There were no chairs, and the music could not be allowed to stop.**

If a bank were to fail, what would the Arabs do with their remaining deposits, now clearly in jeopardy? Further, the inflationary impact of all of this borrowing was also a fact not lost on the OPEC nations. Many of the OPEC members' advisors and ministers held Ph.D.'s from prominent American colleges. They did not have their heads in the sand. The inflation would lead to a new price of oil just to recapture the value that was lost, and the cycle would intensify in the next round. OPEC knew the western currencies were depreciating faster they were compensating with price hikes. They were getting less "real" money as a result. Hopeless.

Remember Jelle Zijlstra with the "moon" comment earlier? **As head of the BIS in 1980, he confidently predicted that the Second Oil Crisis could be worked through, slowly, but that the System (international financial system) could not survive a Third Oil Crisis--the inflation would make it impossible to recycle the petrodollars to the oil importing countries with any hope of repayment, trade would crumble, and the System would be brought to its knees.** On that grim note, we need to take a quick look at how the world reacted to the Second Oil Crisis. It opens the door to everything that follows.

By now you are patiently awaiting mention of Gold. There it is. Now back to the story... No, seriously, pay attention here, and things will start to fall into place. I hope you have noticed the few references to oil prices throughout this series. In most cases, the oil was made available at a posted price. In the 1960's, OPEC's posted price was \$1.80 (though sometimes the producers would undercut that to gain an advantage through additional volume), then it was \$2.20, then \$5.12, and within weeks it had been changed again to \$11.65 (in late 1973). By May 14 of 1979 the posted OPEC price was \$13.34 per barrel, but life was about to change. The key element to keep in mind is that oil was not priced directly by the market. It was mostly sold under long-term contracts at posted prices that were set by the producers after careful analysis of what the market could bear under self-determined production levels.

When the Ayatollah Khomeini's revolution deposed the Shah, Iran's 6 million barrel per day production fell off dramatically, and the resulting shortage sent the downstream processes scrambling for sources of oil anywhere to feed their refineries. Many turned to Rotterdam for oil, to fill their empty tanks. The deepwater port at Rotterdam was the principle harbor where huge tankers could be found to deliver oil on the spot, and hence the spot market for oil was often referred to as the Rotterdam market--but in truth, the spot market was available worldwide. This spot market was never meant to determine the price for oil, but was only supposed to supply day-to-day purchases.

Due to the stresses of low supply, the Rotterdam price sailed above the \$13.34 posted OPEC price on Tuesday, May 15, 1979 to \$28, and two days later it reached \$34. Iran immediately took what little production remained and sold on the Rotterdam market. OPEC then set a ceiling price for oil at \$23.50 per barrel, but that was soon broken by Libya and Algeria. Obviously, Rotterdam was the place to sell oil at the best price, so many tankers with long-term contracts for oil stood empty waiting for delivery while ever more of OPEC-member production was diverted through Rotterdam. Countries and many

companies looked at the low levels in their storage tanks, and soon they were rushing to support the Rotterdam market with their business. The "spot" price reached \$40 per barrel as uncertainty about the future brought forth every empty tank or dilapidated tanker out of retirement to be filled.

Gresham's law can help explain this phenomenon-- bad money is spent and good money is saved. Oil was being bought and saved as a store of value, while paper money was spent. The flames of this Rotterdam inferno were eventually cooled as the last available storage tank was filled to capacity. This display of the spot value for oil reinforced OPEC's concept of value, and they had no qualms about raising the posted price to the spot value. Please recall, "We would rather keep the oil than have the paper money." Any student of history will also recall that the explosion in Gold prices also occurred in 1979 to early 1980, showing us Gold priced at \$850 per ounce.

So what exactly has changed in the world since 1980? There haven't been any similar blowups in the pricing of important assets...so how was this wild tiger tamed? Is the money better than it once was? Or are the OPEC nations now suddenly and truly beggars upon the West's doorstep? What happened? Are the multinational banks (once scrambling to hold together the System) now calling the shots with nary a care in the world?

In Part 5, I put an end to this tale, and answer the biggest mysteries about Gold in the easiest of terms. The road will seem so straight and fair to travel, you will kick yourself for struggling through the brambles for so long, and wonder at your neighbors who STILL can't see the path, though it is truly a freeway.

## Part 5 --- Gold, Money, and the Free Market

Before I conclude this commentary, let me first express my gratitude to USAGOLD for hosting this illuminating site, and for the tolerance I've been extended by so many here for my four long posts that up until this moment probably didn't seem germane to the topic of Gold.

On any journey, the first few steps are the most important, and in this case they were also the most difficult--to include enough for context without drifting off-topic. This last part is easy. The task at hand is to provide an explanation of Gold's pre-eminence as a monetary asset. **Gold is, in fact, Money, while the dollar and others are merely currencies--an importance difference!**

I am not claiming to be offering new findings of my own. The inspiration for this tale originated from many sources, comments Aragorn III offered to a small group last month, a knowledge of history, and keen perception. I have been challenged to render this tale into the clearest of terms suitable even for those not acquainted with Gold and worldly economics. If I have succeeded in my challenge, **at the conclusion of this final part you will fully grasp how the free market has managed to provide a sophisticated asset (Gold) at a laughably minute fraction of its relative value. You will know that Gold is Money, and will gain new respect for its "price."** Although this information isn't new, it might be new to you, and hopefully this explanation of financial operations with Gold, together with the background information of the 1970's Oil Crises, will help you anticipate and conclude for yourself an outlook for events ahead, and will also help you to better understand and evaluate the important messages being presented by ANOTHER and FOA, in addition to the other worthy knights of this Table round. Knowledge is power, and with it your destiny shall be yours to decide.

To start, I'm going to paraphrase some specific remarks made by Aragorn III that some people need to hear and think about, though most of the Forum posters are already in tune with this.

"The falling price of Gold has had various effects on people. The common person says, "Of course it is falling, because Gold has been demonetized." The Goldheart knows better, so the falling price has a more remarkable effect, bringing out insecurities and irrationalities of some. Though these people don't question that Gold is money, their insecurities start to question *whether the world really needs money at all...*that somehow this greatest device of mankind has been antiquated. Simply preposterous. If they knew the truth they would confidently buy today at triple the price and call it a bargain of a lifetime. People ask, "Why waste effort to dig up Gold from the ground, only to rebury it in vaults?" I say, "For the same reason the central banks toil to print millions of fancy notes that nobody reads. If you've read one, you've read them all." The effort is needed to prevent cheating, though we easily see the fancy cash does not stem the abusive tide of money from nothing. People also say, "Gold is a dead asset. It does not earn interest." What is the point of such a comment, to demonstrate their naiveté? Did banks not pay interest when coins were stamped from Gold?

You see, it is not the nature of money itself to earn interest, but rather, it is the investment risk that maybe earns a reward. A modern dollar in a shoebox is as a Gold coin beside it. No interest for either. **You should know the interest paid by a bank savings account is not a product of the money itself, but instead it is the rewards on the risk the bank takes with the money you have provided for their investment use.** Sometimes these banks choose poorly, and in those cases even the modern dollar earns no interest, and does not come back at all--lost with the closing of the bank doors. Money must be risked (invested) to expect a yield, and in this regard, the big players in the world risk Gold money as they do paper money (though often not as aggressively), while the small players are content with the shoebox

yield. You are forced to be more aggressive (more risky) with paper because its value dies quickly, unlike Gold that stands forever even in a shoebox of no risk.'

With that, I will now conclude this tale that shows Gold functioning in its role as Money. And because preconceived notions of words often cloud a person's ability to see the case before them, I shall try to deliver this message with the slightest use of such terms as Gold loans, leases, shorts, etc. In fact, I will be so bold as to simply refer to Gold as Money (I will write it as "Money (Gold)" to ensure you know my meaning, but as you read, simply pronounce it as *money*). As far as what you might think is money (dollars, yen, pesos, etc.), I shall from this point forward not call them money, but refer to them by their given name (dollars, yen, pesos, etc.) or else will call them "fiat currency," or just "currency" for short. Fiat means "by decree, and fiat currency is currency because the government tells us it is.

Enough of the preamble. Let's pick up where we left off from Part 4. In days past, the oil exporters had been poor to modest countries scraping by when two things occurred. They discovered that they owned lots and lots of oil, and they also found that the rest of the world had developed a voracious appetite for oil. Think how different the world situation would be today if this supply of oil had simply never existed. We are certainly lucky to have its availability, and it is a reasonable expectation to pay fairly for all that we take. As bald as that statement is, it is necessary because some people have suggested (as Kissinger did in the 1970's) that warfare is a possible alternative to obtain what isn't ours. Such a world!

We've already discussed much of the turmoil that resulted from consumption that outpaced ability to pay. Payment in Money (Gold) was terminated, and many payment scenarios were developed in addition to the ever rising prices in paper currency. While it can be suggested that currency is a reasonable means in which to track balance of trade accounts (equating oil exports with similar value of imports such as infrastructure improvements), it should be readily admitted that paper currency is an unacceptable means in which to pocket one's profits. Book the trade balances with paper currency, but pocket the profits (savings) with Money (Gold). That's what I do every month, too!

Paper currency was falling fast in value when it was no longer tied to Money (Gold), and this was causing international settlement difficulties on many fronts in addition to oil. It is instructive to investigate some of the tools of the international financial System, because what worked for Money (Gold) and currency back then, certainly works for Money (Gold) today. (Please reread the paraphrasing of Aragorn's money comments if you have forgotten them already.)

Back in the 1960's when dollars were still tied to Money (Gold) under the Bretton Woods agreement, the American penchant to spend for goods abroad led Kennedy's Undersecretary for Monetary Affairs, Robert Roosa, to fear a mass "cashing in" of these dollars in international hands for Money (Gold)--a run on the Treasury. Roosa created a new financial device, referred to as a "Roosa bond," which was a special issue of Treasury bonds that were denominated in Swiss francs. As the bonds were sold to the world, they would sop up excess U.S. dollars with the terms that repayment at a future date would be in a given quantity of Swiss francs. (Notice I said quantity, and not value.) While these Roosa bonds stemmed the tide of a possible run on the Treasury, they ended up costing America more because the Swiss currency appreciated versus the dollar during the life of the bond.

In 1978, the U.S. issued 10 billion dollars worth of bonds denominated in foreign currencies (marks or yen) to milk extra life out of a dying dollar system, and the fix lasted until the 1979 Oil Crisis made mincemeat of it. It was an acknowledgment that some foreign investors wouldn't hold U.S. government obligations that would be repaid in dollars worth less than originally spent on the bond. Further, it was at this time that the U.S. promised to sell Money (Gold) from the Fort Knox stockpile to foreign central banks unwilling to hold dollars. (On his last day of office, March 31, 1978, Federal Reserve chairman

Arthur Burns suggested that the entire \$50 billion of the nation's Gold stock be sold for foreign currency in defense of the dollar, at which time the foreign reserves could be used to buy up the collapsed dollar in international markets. While this plan was originally rejected, within three weeks the Treasury Department was forced to announce it would auction Money (Gold) on a regular basis.)

Treasury Secretary Michael Blumenthal pledged in a meeting two days later with top-level Arab businessmen that the integrity of the dollar would be defended vigorously, and asked them to do their part to stabilize the global economy by keeping a price freeze on oil in place at least through 1978. (You should have no questions now about where the dollar found its value after the 1971 delinking with Money (Gold). **The asking price by oil--influenced by many factors--is what established the dollar's value.**)

It is also important to realize that **not all international arrangements are conducted on the open market.** For example, **to avoid the German mark from being bid up in strength** with a result of ever more people bringing them dollars for an exchange, **Germany's Bundesbank issued bonds directly to the Middle Eastern buyers, avoiding the marketplace impact altogether.** This was at the time Saudi Arabia was swimming in cash and spreading the excess among the world's largest banks (as mentioned in Part 4). My point is this (which I shall expand on soon): **don't be surprised that banks are far more creative in their operations than revealed in your common experience through savings and checking accounts and home loans.**

Eliyahu Kanovsky, an oil economist, won renown by many for accurately forecasting long-term oil production and pricing trends by OPEC where all others had gotten it wrong. In the 1970's he maintained that **economics, not politics, were the determining forces behind the decisions of OPEC.** In 1986 he wrote in response to the prevailing notion that OPEC would eventually own the world as a result of its oil wealth: "It is, by now, abundantly clear that these forecasters committed gross errors not only in terms of magnitude of change, but, far more important, in terms of direction of change. Instead of increased dependence on OPEC and especially Middle East oil, there has been a very sharp diminution. ... Oil prices have been weakening almost steadily since 1981 and there has been a collapse since the end of 1985. Instead of rising 'petrodollar' surpluses, most OPEC countries, and Saudi Arabia in particular, are incurring large current account deficits in their balances of payments, and are rapidly drawing down their financial reserves."

In the 1990's, Kanovsky maintains that OPEC has lost its ability to raise income through raising prices, and that oil below \$20 is virtually assured. (This should remind you of Milton Friedman's poor prognostication from Part 1.) Kanovsky claims competition among producers ensures an end to price fixing. They can only pump it and sell it for whatever the market will provide. He contends (rightfully so) that Iraq can be counted on to "pump like mad" upon lifting of UN sanctions. He also contends that with the current account deficits of many OPEC members, notably the Saudis, they have no option themselves but to add to the oil glut with overproduction to raise revenue.

Since it has been brought to our attention by Kanovsky, let's take a look at the Saudi budget, and the toll taken on it in the aftermath of the Gulf War. IMF data reveals that the Saudi deficit climbed from \$4.3 billion in 1990 to \$25.7 billion in 1991. Oil had been selling at around \$14 per barrel until June 1990 when Saddam Hussein pressured OPEC to raise the price to about \$20 to help repair Iraq's national budget (which had been wiped out and sent into the red by their 1980-88 war on Iran). Iraq's subsequent invasion of Kuwait in August 1990 temporarily spiked the price higher.

Here I must ask you to pause for a moment to reflect on those huge oil trade surplus figures we toyed with in Part 3, and recall that they were from early 1970's oil demand at a price of \$11.65 which caused the First Oil Crisis. What happened to the vast amounts of petrodollar revenue that was being pumped into international banks, and recycled as fast as the loans could be written to borrowers throughout the

1970's? Further, what happened to the earnings that were surely being generated on these deposits through the activities of the lending institutions? As I noted at the end of Part 4, the System miraculously survived the Second Oil Crisis of 1979, and concurrently the skyrocketing price of Gold promptly abated in 1980. Further, Kanovsky points out that oil prices started weakening in 1981, and then plunged in 1985. Force yourself to make the connections. You will be one step ahead of Kanovsky, who has identified the effect, but no doubt has missed the cause entirely. Let us now tie together everything we know, and fill in the remaining pieces.

Historically, the price of oil had been simply posted by the producers for contracted delivery until it was unleashed to respond to daily supply/demand forces on the "spot" Rotterdam market, at which time the price exploded in 1979-80. Although the dollar had been historically fixed to Money (Gold), after it was unpegged in 1971, the currency price of Money (Gold) was determined by the daily supply and demand, similar to Rotterdam. Gold auctions began in May of 1978 because the U.S. had trouble getting international entities to accept its dollar currency. After "booking" their trade balances with dollars, the House of Saud, among others, wanted to "pocket" their profits with Money (Gold), and therefore competed with everyone in the world for Gold on the spot market. As the price shot right through \$700 **it was clear that every ounce purchased made it that much more difficult to purchase the next ounce.** There was little trouble raising the price of oil as needed, except the financial structure of the world was coming apart at the seams. Each dollar withdrawn from international banks to buy Money (Gold) made life ever more difficult for the banks to square their books against outstanding loans or to write new loans. There had to be a better way...the return of Money!

The high price of Gold brought mining companies out of the woodwork. The Earth was suddenly crawling with geologists looking for the next jackpot Gold deposit. The mining companies needed capital to finance the construction of these numerous new mines. **It's not strange to you to accept that banks can lend currency. It should not be difficult for you to accept that banks can lend Money (Gold) also.** Struggling with that thought? Don't. They lent Money (Gold) in the days prior to Roosevelt's 1933 confiscation of Money (Gold) in exchange for currency, and they can lend Money (Gold) today. In fact, they can even create Money (Gold) out of thin air, in a manner of speaking, and I'll walk you through it.

Sometimes a parallel familiarity assists comprehension. Consider the existence of Government-Sponsored Enterprises (G-SE's) such as the Federal National Mortgage Association (commonly known as Fannie Mae). Fannie Mae is in the business of creating financing for people to acquire a house. The government's involvement in this affair is that they underwrite the risk of a default on the repayment of the loan. **Dollars are borrowed, dollars are lent, and dollars are repaid. It doesn't matter what happens to the exchange rate of the dollars versus other currencies.** A certain amount of dollars are owed, plain and simple, under the terms of the loan contract. **If a home mortgage loan is sold on the secondary market, the purchaser of the loan is effectively buying not the house that was financed by this loan, but rather the rights to receive the borrower's scheduled repayments over a span of time.**

**Think of a loan to a mining company in a similar fashion.** Interest rates on Money (Gold) loans are often much less than on currency loans because the Money (Gold) holds its inherent value over time (despite its "price,") whereas the paper currency fails so fast you must return more for the lender to at least break even, not to mention show a profit for the risk. Because miners will be pulling Money (Gold) out of the ground, it makes the most sense to them to seek a loan of Money (Gold) rather than currency in order to finance their new mine construction. But because Caterpillar has its head in the sand, it requests dollar currency for the purchase of its mining equipment, so an exchange must be made for paper currency as an integral part of this Money (Gold) loan. These arrangements can take place in every conceivable fashion, but this following example will be representative.

As 1980 arrived, the Saudis naturally still wanted Money (Gold) for their oil, and the rest of the world was struggling with liquidity. Much currency "wealth had already been transferred to OPEC, leaving

many countries toiling to service their own debts--much of their credit existing as recycled petrodollars. Let the lending continue! Bullion banks would facilitate these deals, and central banks (CB's) would act in the same capacity as with the G-SE Fannie Mae, guaranteeing ultimate repayment in the event of a borrower's default. In this simple example, the House of Saud could be looked at as the principle lender (although the borrower doesn't see this)...providing the currency equivalent of the Money (Gold) borrowed by the mining company to pay for Caterpillar's equipment to build the mine. Because this is contracted as a Money (Gold) loan, Money (Gold) must be repaid over time. **In a sense, from the Saudis' viewpoint it is similar to the Roosa bonds where U.S. dollars are paid for the bond, with a fixed amount of another currency (in this case, Money (Gold)) expected to be returned upon maturity.**

With the simple but vital central bank guarantee against the default of these Money (Gold) loans, the House of Saud, for example, would have no qualms about supplying the cash side, **effectively buying not the Gold metal immediately, but rather the rights to receive the borrower's Gold repayments over a span of time. Just like buying a home loan on the secondary market. And the Money (Gold) of the central bank need not ever move or change ownership unless the borrower defaults on the loan, and the CB is obligated to deliver on its guarantee for the full repayment in Money(Gold).**

There is nothing sinister in all of this. The price of Gold has fallen simply because anti-gold sentiment has been fostered throughout the common investment markets **while the principle buyer at the Golden "Rotterdam market" had found another avenue in which to obtain the Money (Gold) desired in exchange for oil profits. This is very much like the off-market Bundesbank offerings** that I mentioned about earlier. Please appreciate the patience in this approach, and the commitment it shows to Money (Gold), knowing full well that for many years it might be getting ever cheaper, while they would appear the fool for buying it from the top prices all the way down to the lowest. But the big payoff is in the end--which is near--and I'll get to that.

Now that you grasp the basics, let's take things up one level. So many Money (Gold) loans were written, that the House of Saud in our example spent down their past petrodollar surpluses. What now? It is time for banks to do what banks do best...create *new* money. This is the typical example I promised you earlier:

The miner approaches a bullion bank for a Money (Gold) loan. Let's assume the current dollar price of Money (Gold) is \$400 per ounce, and the miner needs \$20 million to pay Caterpillar for equipment. **The bullion bank** (such as can be found operating in the network of the London Bullion Market Association--LBMA) **writes the Money (Gold) loan contract specifying the term of repayment of 50,000 ounces of Money (Gold) plus interest at 1% - 2%.** The borrowing miner collateralizes this Money (Gold) loan with company stock, the deed to the mine, etc., and is sent down the road with \$20 million in currency for Cat. Where did this cash come from? The bullion bank turned to the House of Saud, which is currently out of currency. However, **using their oil in the ground as collateral, the bullion bank is able to write them a currency loan out of thin air (just like banks can do) with which the Saudis purchase the repayment rights on the Money (Gold) loan. They will be receiving future Gold for their future oil! As they sell oil, they will use their dollar revenue to repay their currency loans, and in the meanwhile, the miner's Gold loan repayments will be directed to the Saudis' account.**

What does the bullion bank get for all this trouble? First, the central bank gets 1% - 2% for underwriting or guaranteeing the loan. (Just like the underwriting done with Fannie Mae.) The bullion bank had added on top of this low interest rate an applicable margin for its cost of funds to establish the final interest rate for the miner that borrowed the Money (Gold). This rate might run 3% - 5% (while currency loans would demand much more.) Each year the miner produces Gold, and after paying the required installment of Money (Gold) for the Loan, the remainder of his annual production can be sold on the spot market for currency used to meet business expenses.

There's one hitch. Because the biggest Gold buyer is no longer shopping on the spot market, the pricing pressure has come off, and prices could very well be expected to fall. To protect against this leading to the possible bankruptcy of the miner, and hence his default on the repayment of Gold, the terms of the Loan might also require that the miner lock-in a certain amount of future production at the current Gold prices at the hedging counter. (Economists first scrutinize the mining plan to ensure that it will in fact be viable at current prices before granting the Loan.)

As described so far, it should come as no surprise that the House of Saud would also step right up to purchase the delivery side of this hedged production. Enough must be hedged to ensure the mine will remain viable (even at lower prices) at least long enough to repay the Loan. Lets assume this mine is operating today with Money (Gold) at \$260 per ounce, while their cost of production is actually \$320. The current price of Money (Gold) is not a factor on the Loan repayment...they owe 50,000 (plus interest) ounces, regardless. Any additional production would be sold under the terms of their hedge, at \$400 per ounce, and they can pay their bills comfortably and stay in business. Is the House of Saud a fool for paying \$400 long ago for the Loaned ounces, and for paying \$400 today to honor such hedged ounce agreements? You or I could pay \$260 today for that same ounce on the spot market. Have you started to develop a new opinion of your currency, or at least a new opinion of Money(Gold)?

OK, so what else does the bullion bank get out of this, other than the applicable margin on the Money(Gold) loan mentioned above? It also collects the interest on the currency loan that was written to the Saudis using their oil as collateral. You can see how the mechanism that has brought us temporarily cheap Money (Gold) over the years has also given us cheap oil not subject to the same shocks witnessed in the Seventies. You can also see why the economists can look at the Saudi balance books and see tremendous currency debts and budget deficits where once there were surpluses that threatened to buy up the world. They have in fact bought up a significant portion of the Gold mined well into the future...through Loans and Hedges bought all the way down from the top. So who are we to question whether to exchange our currency for Gold now or tomorrow, and to gripe over a missed opportunity of \$10? The equation is simple. If you have cash, buy Gold immediately, because the downward trend has become terribly unstable. Here's why...

The various financial Hedge Funds saw how easy it was for miners to raise low interest capital, and further appreciated the fact that even if they were not themselves a producer of Gold, the Gold itself needed for repayment could be purchased on the spot market at ever lower prices. The Hedge Funds could meanwhile invest the capital received through taking out this Loan and expect to have a double profit potential in the end. (The infamous Gold Carry Trade would invest the currency received through the 1-2% Gold Loan into U.S. bonds that yield over 5%.) And of course, with the proper central bank guarantees, the House of Saud would be there to buy up the repayment contracts expected on these Money (Gold) loans also.

The problem is that these speculating Hedge Funds have cumulatively driven the price so low (well beyond where mines would have long ago stopped seeking this type of Loan) that some unhedged mines are shutting down or going bankrupt. This aggravates the spot market with thin supplies of real metal reaching it (due to so much production already having delivery obligations) such that it becomes hypersensitive to any real effort to make substantial purchases there.

As a result, the Hedge Funds will be in for a rude awakening in their efforts to purchase the Gold needed to repay their Loans. And the bullion banks are sweating, because they stand next in line having facilitated the Money(Gold) loans and pledged to the CB's that they were credit worthy of the CB Gold guarantees. And the important Oil Producer sees that the big bucks paid long ago for future Gold delivery has actually purchased only uncertain arrival. And further, some miners, despite their hedges, have played fast and loose liquidating them for cash, and through general mismanagement have not been able to stay so viable as to ensure future operation and delivery of the repayment terms.

The CB's are fretting because their guarantees were used over and over again, and they are on the hook for a lot of Money (Gold) when the speculating Hedge Funds and bullion banks find it impossible to cover their Loan repayment obligations on the spot market as the price races away from them due to the hypersensitivity that low supply has caused. Shades of Rotterdam. Currently aggravating this spot market problem is the massive demand by individuals brought about by the low prices and concerns for Y2K. I hope this give you new perspective on the push lately by some CB's to free up some Money (Gold) from the vaults, whether it is Bank of England, IMF, or maybe even Swiss. It should also give you perspective on the anti-gold propaganda delivered regularly by the media. Consider that a skyrocketing price of Gold would not only be viewed by the masses as a viable investment avenue, it would also tend to shake the confidence in paper currencies, and threaten the banking system and Wall Street in general.

It is this same currency, borrowed against oil collateral for the purchase of Gold, that has added the massive liquidity to the world over the past decade and a half that many people have used in turn to fan the flames of the stock markets here and overseas. That's a lot of cash born unto Gold, and were it not for the prospects of receiving the real wealth of Gold metal, this supply of currency would have been stillborn, and oil would likely only come forth by way of brute force rather than by civil, economic means. I realize that I have left a lot out, but this should get you started along the clear road traveled by smart currency. Now, knowing what you know, what would you do with your dimes? Because this is really his tale, not mine, I'll leave you once again with perhaps my favorite statement made by Aragorn one evening last month among his old friends. "If I were given a dime for every time I cursed the market for providing easier gold, I'd have a dime...and that one was found on my way over here.

Everyone, your comments are welcome. And thanks again to MK for the USAGOLD forum and for the opportunity to obtain a world-class Money education and shiny yellow metal diplomas all at the same place!

**Gold. Heading to the moon at a world near you. ---Aristotle**