

GOLD & ENERGY ADVISOR

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“The ‘Secret’ Mechanism Behind High Gold Prices!”

“Gold and oil have hit spectacular new highs in the last month. Now they’re correcting temporarily, as I told you they would. (Make sure you read my email Updates and Real Wealth issues for up-to-date market commentary and analysis.)

“Over the longer term, both gold and oil will continue to go up. It’s inevitable. It’s also mysterious to most Americans, who don’t understand how our economy works.

“This is Chapter Four from the new edition of my gold book. Read on to understand how the Federal Reserve System will push gold prices up to \$2,500!”



James DiGeorgia, Editor

Five years from now, what will the dollar be worth?

Obviously, we can’t know this, but one thing is for sure. In five years, the dollar’s purchasing power will be less than it is today. Probably *much* less.

Year after year, the dollar falls in value. Few people pay attention to this, or even realize what an impact it has on their investments. Those who understand it can not only avoid its destructive power, they can profit from this ongoing (and inevitable) process.

This chapter focuses on the fate of the United States dollar, and monetary inflation in the American economy. As the dollar plunges in value—in other words, as inflation goes up—gold’s value soars. Over the next few years, the dollar will be under severe inflationary pressures. That’s why it’s so important to invest in gold.

In this chapter, I’ll discuss:

- What inflation is, and what causes it.
- Why inflation drives up the price of gold, even faster than the inflation rate itself.
- Why our economy is now inherently inflationary, and how this will affect our investments in the future.

What is Inflation, Anyway?

There is tremendous confusion in our country about inflation: where it comes from, and how to reduce it.

Many people think inflation just means prices are going up. Rising prices are closely associated with inflation—but prices are the symptom, not the cause.

If this weren’t true, then solving inflation would be simple. The government could just force businesses to stop raising their prices. But the failure of President Nixon’s price controls in 1971-1973 proves inflation is caused by something else.

Nor is inflation the result of consumer psychology. If it were, then President Ford’s “W.I.N.” (Whip Inflation Now) campaign in 1974 would have worked. But it didn’t.

As Nobel Laureate Milton Friedman famously revealed, “inflation is always and everywhere a monetary phenomenon.” When the money supply rises, more money chases the same amount of goods and services. Therefore, prices go up.

Of course, prices can still rise for non-monetary reasons—but *not across the entire economy*. For example, a hurricane in the Gulf of Mexico can damage oil and gas platforms, which will drive up the price of energy. However, if the money supply doesn't expand, prices in one or more other markets will be forced down simultaneously.

When there's only so much money in the economy, increased spending in one sector will decrease spending elsewhere. Therefore, even though supply/demand

forces can drive prices up in one market, prices will decline in one or more other markets.

For prices to go up across the entire economy, the money supply must be expanded. That's the meaning of inflation.

Political Hypocrisy

Inflation isn't difficult to understand. Nevertheless, politicians can't seem to comprehend it.

Our government has direct control over our money supply. Therefore, inflation is the direct result of decisions made by government officials. But in times of high inflation, when voters are angry at their rising cost of living, these same officials deny any responsibility. Universally, they blame someone else—greedy business owners, or irresponsible mortgage companies, or haughty oil sheikhs. Anybody but themselves.

This is why most Americans don't understand the true source of inflation. Government leaders (who should know better) continually mislead the public.

We can't do anything about this. But we can profit from it. And the best way to do so is through gold.

Why Gold Benefits from High Inflation

Historically, gold has always been a great investment during inflationary times.

There are several reasons for this. First of all, gold is priced in dollars. Thus, as the value of each dollar goes down, more of them will be required to buy the same amount of gold.

Of course, you could make the same argument for food, clothing, stocks and bonds, or anything else priced in dollars. Why then is gold the primary 'safe haven' for investors during inflationary times?

Because gold has a unique combination of characteristics that make it a superb counter-dollar investment. Most of its attributes that we discussed in Chapter One become even more attractive as the level of inflation increases. Gold's liquidity, inherent value, fungibility, portability, privacy, and immunity to counter-party default all cause investors to stampede into the metal when their national currencies plunge.

As a dollar-priced investment, gold should 'automatically' rise as the dollar falls. As a safe haven for investors, gold's demand will also rise as the dollar falls. So we can anticipate the metal will go up even faster than the dollar goes down.

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What is the outlook for the dollar over the next few years? To answer this question, we first need to look at its recent history.

A Century of Constant Inflation

Historical inflation data are available going back to 1913. Although its annual rate goes up and down, its long-term average is 3.44 percent.

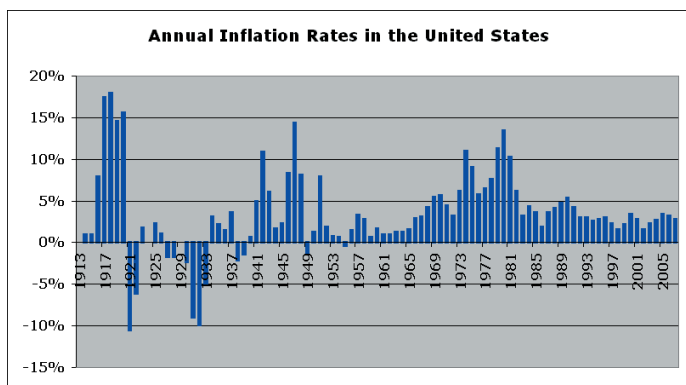


Figure 4-1: Inflation rates can be volatile, but their long-term average is 3.44 percent.

That might not sound like much. But year after year, decade after decade, every dollar in every account you own is decaying. Rotting away. Losing its purchasing power.

The impact of this comes crashing home when you consider the erosion in the dollar's value over the last century or so.

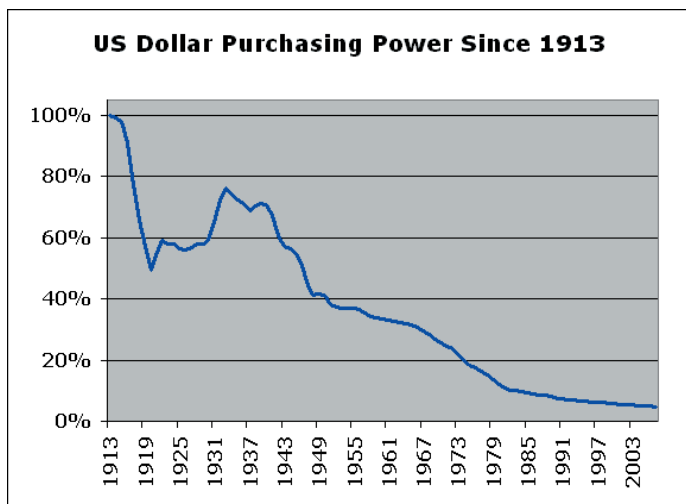


Figure 4-2: The dollar has steadily lost its value by inflation.

If we use 1913 as our index, we see that the dollar's value today is down to 4.8 percent of its value then.

In other words, it now takes one full dollar to buy what 4.8 cents used to buy.

You might be unimpressed by this. Ninety years is a long time, after all. So let's look at inflation's effects over only 25 years.

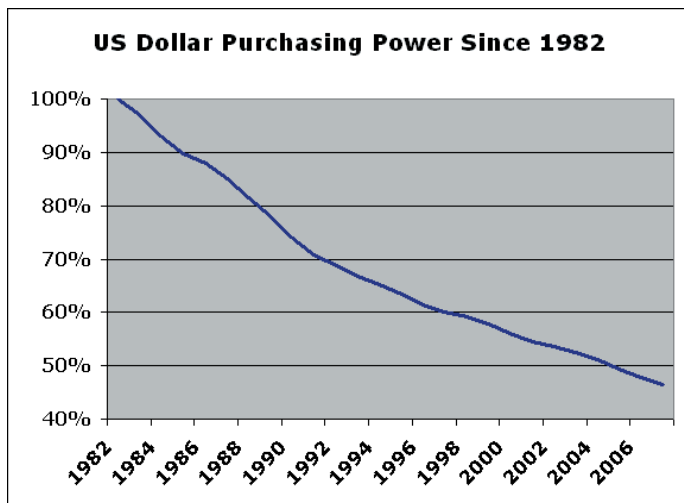


Figure 4-3: 25 years of inflationary dollar decay

Using 1982 as the 100-based index, the dollar's value as I write this in early 2008 is 46.6.

That means the dollar has lost more than half its value in just 25 years—a time frame short enough to concern all of us.

And this is during a time of relatively *benign* inflation. In the late 1970s, annual inflation in the US went as high as 13.5 percent. That's why gold prices went ballistic.

With all the troubles the dollar is facing over the next few years, we could easily reach these levels again. If we return to double-digit inflation rates and stay there for even two or three years, \$2500 gold will be achieved easily.

So what causes all this inflation? Why is it that year after year, the value of our savings goes down while the prices we pay keep going up?

It wasn't always this way. In fact, if you think about it...

A Healthy Economy Should Not Experience Long-Term Inflation

In the past, prices remained stable for decades—sometimes even *centuries*.

For example, in the United States, the cumulative CPI (consumer price inflation) from 1820 to 1913 was *zero*. In England, the average price of consumables rose less than 0.4 percent from 1210 to 1940—a period of more than *700 years*. Other examples could be given as well.

This makes sense if you think about it. As the population grows, demand grows too (for food, clothing, shelter, etc.). At the same time, supply of those things expands. (The labor force needed to grow/create/build everything gets bigger.) So supply and demand remain balanced, and prices are stable.

Today, with modern technology, prices should actually *decrease* every year. Alternately, prices

might remain stable, but the quality or quantity per unit price should increase.

For example, consider the personal computer industry. Every year, better technology becomes available, and costs less than ever before. There's no reason why *every* modern industry shouldn't experience the same effect. Our entire society is based on technology, which improves every year.

So why don't we see prices dropping every year? We would, if our economy was neutral. But Western economies are now inherently inflationary—so much so that they overwhelm the underlying deflationary trends of all but the most vibrant industries.

Latest prices as GEA goes to press— March 27, 2008

Comex spot silver contract:	\$	18.23
Comex spot gold contract:	\$	946.00
Nymex spot platinum:	\$	2,033.00
Nymex spot palladium:	\$	450.00
Nymex Light Sweet Crude Oil:	\$	106.00

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How the West Went Wrong

In a previous chapter, we saw how Western economies used to be based on the gold standard. Since the gold supply grew very slowly (and required lots of labor and expertise to do so), inflation was minimal. The metal's inherent stability provided a rock-solid foundation for these economies.

But then the West started to abandon gold. One by one, governments created central banks to 'manage' their money supplies and economies. Our own version of this is the Federal Reserve, which was created in 1913.

Unfortunately, most Americans are clueless about the Fed and how it works. There's an excellent reason why those earlier inflation graphs start in 1913. This is the year the Fed started to 'manage' our economy, and...

The Federal Reserve System is *inherently inflationary.*

So we've experienced pernicious, relentless inflation ever since.

The history of the Fed is a fascinating subject, but it's beyond the scope of this book. Despite its name, the Federal Reserve is not Federal—it's a private entity, not a government agency. Nor does it have a Reserve.

Initially, the Fed was set up as a collaboration between the Federal government in Washington and private banking interests in New York. The government wanted a way to increase its spending without having to tax the voters. The bankers wanted a "lender of last resort," so they could make as many reckless loans as they liked without fearing a bank run. They also had certain other reasons that I'll describe later.

The Fed was created to serve these purposes.

Over the years, the Fed has taken on many additional functions as well. Today, most Americans are only aware of the Fed's role in managing short-term interest rates.

However, this isn't even the Fed's most important role. Far from it, in fact.

Of everything the Fed does, these three have the largest impact on the economy:

- It monetizes government debt.
- It controls reserve requirements.
- And it acts as a lender of last resort.

As it turns out, *all* these roles require the Fed to inflate the money supply. That's what I meant when I said the Federal Reserve System is "inherently inflationary."

Let's discuss these roles briefly.

Monetizing Government Debt

Ever wonder where a dollar comes from?

Obviously, the paper currency in your pocket was printed at the US Mint. But why was it printed? And how did it enter our economy? For that matter, what about the 'electronic' dollars in your bank account—all those numbers stored in the bank's computer?

They were all created out of thin air by the Federal Reserve System.

The Federal Reserve has a magic checking account that can never be overdrawn. Even though it's empty, any check written against it will always be good. Each time a check clears against this account, the dollars are created out of thin air to provide the funds for the check.

If you or I tried to do this, we'd go to prison. But the Fed does it every day.

Anyway, here's how money enters the economy. The federal government sells a Treasury bond to the Fed. Since the Fed has no money of its own, it buys the bond with a check from its magic checkbook. When the government deposits the check into a Federal Reserve bank account, the money pops into existence and appears in the account.

There's an important point here. For money to be created, the government must sell a bond to the Fed. In other words, the government has to go into debt.

Of course, the government can sell bonds to other buyers: private investors, institutions, even foreign governments. In all of these cases, the government

still goes into debt, but no new money is created. Quite often, though, when the government offers bonds at low interest rates, no buyers will accept them. That's when the Fed steps up and buys them instead.

This is the primary reason the Fed was created back in 1913. It allows politicians to spend an infinite amount of money—they can literally *borrow it into existence*.

Not only that, they avoid the market's discipline of higher interest rates. Normally, the market would charge higher rates to anybody who is borrowing themselves into bankruptcy, as our government is doing. Higher rates would tend to discourage the borrowing, and correct the borrower's behavior. But the Fed system allows Washington to sidestep that discipline. (More on this in the next chapter.)

Back to the creation of money. After the Fed creates the money, the government writes checks to civil servants, military members, Social Security and Medicare recipients, and others. They receive the new money, and spend it on goods and services. Thus, the new dollars spread quickly throughout the economy.

But that's only part of the story. The money also spreads and multiplies indirectly.

As the government sends out its checks, the recipients deposit them into commercial bank accounts. Under the Federal Reserve System, banks are allowed to lend out money from their reserves—in other words, from the deposits in these accounts.

So as banks take the new money as deposits, they also loan it out. And they're eager to do so, since the interest on these loans is the primary source of their profits.

Here's where it gets interesting. Banks can loan out *more* than the deposits they receive. This is related to the Fed's second major role in our economy, which is...

Setting Reserve Ratios

One of the ways the Fed 'manages' the economy is by setting the fractional reserve ratio. As I write this, it's set at 10 percent, so I'll use this number to explain how it works.

With the ratio at 10 percent, banks are only required to maintain 10 percent of their reserves. So for every \$1 million that arrives as government checks, they have to keep \$100,000 on hand for funding ATM withdrawals, check-clearing, and so on.

The other \$900,000 is “excess reserves.” Since the banks aren’t required to keep it, they lend it out as quickly as they can via mortgages, personal loans, credit cards, etc.

But wait a minute. That \$900,000 doesn’t belong to the banks—it’s part of the \$1 million that was deposited by the banks’ customers. So how can the banks lend it out?

It’s easy—they don’t. Every time a bank makes a loan, its depositors’ accounts don’t shrink. Instead, the money for the loan is created out of thin air!

And the story doesn’t stop there. Much of that \$900,000 in loans goes out as checks, which are then re-deposited into the banking system by the recipients. These new deposits are classified as new reserves... which means the banks can lend *more* money.

Of course, the size of the loans will be a bit smaller this time: only \$810,000 (90 percent of \$900,000) can be lent out. Those loans will also be re-deposited, and turn into another smaller wave of loans (\$729,000)... and so on.

The merry-go-round continues until the loan amounts have shrunk down to zero. By that time, the initial \$1 million has multiplied into \$10 million. So each time the Fed creates \$1 million, the banks can create an additional \$9 million.

Strictly speaking, the banks’ actions aren’t inflationary. With each dollar they create, a corresponding dollar’s worth of liability (owed by the borrower) is created with it. In a sense, the bank has created both a positive dollar and a ‘negative’ dollar simultaneously, which together equal zero.

For example, let’s say you have a personal line of credit at your bank. You use it to buy something at a store for \$500. That \$500 is created from nothing by the bank and transferred to the store. Your bank has expanded the nation’s money supply by \$500, while also creating a \$500 debt (owed by you).

A month or so later, you transfer \$510 (\$500 plus interest) from your checking account to the line of credit. Your bank pays off the loan with \$500, and keeps the \$10 as its profit.

When the bank applies the \$500 to the debt, the debt disappears. Importantly, the \$500 payment disappears too—it no longer exists. Those dollars are re-absorbed into the banking system.

By borrowing money from the bank, you expanded the money supply by \$500, while simultaneously creating a \$500 “hole” in the banking system. When you paid off the loan, the hole is filled back in and the money supply shrinks back down.

Therefore, when the banks create money, the new dollars appear and bounce around the economy for a while, then disappear again. Inflation occurs, but only temporarily.

Note two things though. First, all that money sloshing around has a definite inflationary effect. When people are flush with cash, they spend more freely, even if they know they’ll have to repay it later. So the new money might be temporary, but it has an inflationary impact on prices anyway. And “temporary” is a relative term: a 30-year mortgage loan can expand the money supply for three decades.

Second, you now see why the bankers eagerly cooperated with the government in creating the Federal Reserve System back in 1913. The banks get their profits by charging interest on the money they lend out—*which they create out of nothing!* Wouldn’t you like to have a cash machine like this?

A Lender of Last Resort

The bankers also wanted the Fed to be a lender of last resort. At the turn of the 20th century, bankers lived in fear of bank runs. When a bank lent out too much of its reserves, or made loans that went bad, depositors rushed to get their money back. And the bank would collapse.

As a result, bankers had to be very cautious with their depositors’ money. Of course, the bankers hated this fiscal discipline. So when the Fed was created, the bankers made sure it could act as a lender of last resort. When a bank had lost so much money that no other bank would lend to it (for fear of losing its money too), the Fed would step in and bail it out with its magic checkbook that never ran out of money.

This was originally supposed to protect banks, but politicians quickly saw the advantage of using it for other purposes as well. Today, banks and other large institutions are rarely allowed to fail anymore.

Thanks to the Fed, the government has not only bailed out a long list of banks, it has also created billions of dollars to rescue private companies: Penn Central Railroad, Chrysler, Lockheed, and others. As I write this, the collapse of troubled Wall Street investment bank Bear Stearns was just averted with a buyout offer from J.P. Morgan—one where the Fed is providing up to \$30 *billion* in financing, because no sane lender would get involved in this stinker.

Each time a bailout occurs, the public is told to breathe a sigh of relief. After all, once an institution gets “too large to fail,” it would be a national disaster to let it go under. The Fed has saved the day once again, and we should all be thankful.

But in reality, the only people who benefit from the bailouts are the bankers and executives who get the money. The rest of us suffer.

Thanks to the “lender of last resort,” banks and financial institutions have become wildly reckless today, and why not? If they place large speculative bets on the bond markets, which turn against them... or if they lend billions to Russia, Mexico, and Argentina, who were all predicted to default on the loans (and proceeded to do so)... or even if they commit outright fraud by embezzling money from their depositors... it doesn't matter. Uncle Fed will step in and prevent the market from disciplining them. (In fact, Uncle Fed *has* stepped in for each of these situations—these are all real examples.)

Plus, each time the government bails somebody out, the dollar gets inflated further. Your cost of living goes up, and the value of your savings goes down. Everybody loses—except the guy who got the billion-dollar check. There's a big smile on *his* face.

One of the reasons capitalism works so well is that the market punishes bad behavior, *which discourages others from committing it in the future*. By preventing pain in the short-term, the Fed creates pain for all of us in the long term.

So why is this system allowed to exist? We've already seen why the bankers love it. And we've also seen why politicians love it. But there's an insidious aspect to inflation that few Americans understand...

How the Government Uses Inflation to Steal From You

As the Fed pumps more and more dollars into the economy, prices go up. The value of the dollar falls. The purchasing power of the dollars in your wallet and your bank accounts goes down.

But where does this value go? It seemed to vanish, but that's impossible. Purchasing power can't just disappear.

Here's the answer—it didn't go away. The government took it from you.

As we've already seen, the Fed creates money when it buys a bond from the government. The instant those dollars spring into existence, the money supply has been inflated.

However, prices haven't yet gone up in response. They don't do that until the money circulates around in the economy. And the money doesn't circulate

Portfolio Update

In Update #474, we issued instructions for subscribers who sold calls on Devon Energy (DVN) and Apache Corp. (APA). We rolled up some of our hedges.

On Apache Corp., we rolled up our March \$100 calls (APACT) to the April \$100 calls (APADT). This brought our cost down to \$38.65.

On Devon Energy, we rolled up our March \$80 calls (DVNCP) to the April \$80 calls (DVNDP). This brought our cost down to about \$60.40.

In Update #475, we sold Provident Energy Trust (PVX) for \$10.57.

We also rolled up our options on Encore Acquisition (EAC)—we closed the March 25 calls (EACCE) and opened the June 25 calls (EACFE).

We also rolled up our options on Pioneer Natural Resources—we closed the Apr. 25 calls (PXDCI) and opened the Apr. 45 calls (PXDDI).

In Update #478, we issued instructions for subscribers who wrote options against their ConocoPhillips (COP) and Noble Corp. (NE) positions.

On COP, we rolled up our March \$75 calls (COPCO) to the April \$75 calls (COPDO). This brought our cost down to \$30.10.

On NE, we rolled up our Mar. \$47.50 calls (NECW) to the Apr. \$47.50 calls (NEDW). This brought our cost down to \$29.37.

In Update #480, we took profits on Ultrashort Oil & Gas Proshares (DUG). We made a 7% return in one month.

In Update #481, we bought Occidental Petroleum (OXY). We recommended shorting the April \$70 put (OXYPN) to acquire the stock.

until the government spends it on Social Security and Medicare benefits, military hardware, federal payroll, and other such expenses.

Even though the dollars fall in value as soon as new ones are created, the government gets to spend them before the decline manifests itself. In effect, the government spends the new dollars at their pre-inflation value.

Put another way, it spends them for more than they are worth. Where did their extra purchasing power come from? It came from your bank account.

Now we see why government officials formed the Fed back in the early 1900s. Before the Fed existed,

politicians had three ways to fund their spending: taxes, borrowing, and printing money. All three were uncomfortably transparent to voters, who could scrutinize every nickel Washington spent.

Thanks to the Fed, Washington can now inflate the dollar almost invisibly (since few people understand how it works). Politicians can bleed purchasing power out of American voters without anybody even noticing. This is a *great* deal for politicians who are addicted to spending, but who also want to appear to be fiscally responsible.

In fact, we might wonder why the government even bothers with taxes at all. After all, the Fed can just create money out of thin air, as much as the government needs—so why collect taxes at all?

Why inflict the torturous tax code on the American public, along with the huge legal and administrative infrastructure necessary to support it?

If you were cynical, you might notice that focusing the public's anger on the IRS and other oppressive tax agencies distracts the voters from how the system really works. If you weren't cynical, you might decide politicians are too incompetent to understand the government they're supposed to be managing.

I'll let you decide which option is scarier.

Four Reasons Why Our Economy Is Now Inherently Inflationary

We've seen three ways by which the Fed inflates the money supply: monetizing government debt, allowing banks to create money out of thin air, and periodically creating a blizzard of new dollars to bail out troubled institutions.

We can add a fourth reason why we should expect permanent inflation from now on. Over the last century, there has been only one period without inflation: the Great Depression.

The Depression had several causes, which are out of the scope of this book. What's important here is that government officials blame monetary policy for this troubled time.

Specifically, government and Fed officials believe the Depression was caused by an under-inflation of the money supply. (They're wrong, but that doesn't matter here.) Current Fed Chairman Ben Bernanke believes this strongly, and has said so repeatedly.

Therefore, our government will always try to inflate itself out of every economic problem that occurs. There is almost no financial trouble which will not cause the government to drown the economy in liquidity.

For that matter, the government won't let inflation stop, even if no financial crisis ever occurs again. Our leaders today are dominated by the neo-Keynesian model of economics. According to this model, prosperity can be imposed on a nation indefinitely, as long as the money supply is inflated continuously.

This model is wrong, of course. Continual inflation will distort the economy so badly that a series of financial bubbles will form and burst, growing larger each time until the whole structure comes crashing down.

But it doesn't matter that the model is wrong—it only matters that this is the model our government officials use.

Therefore, inflation will never stop—ever. As Fed Chairman Bernanke has said, the government has a technology called the printing press—and it will print as many dollars as necessary to accomplish its will.

Great for Gold Prices

A century ago, our monetary system was based on a rock-solid foundation of gold. Today, that stability is gone. Now, our entire monetary system is built on the Federal Reserve System—a system that has inflation built into its core.

We've seen that under a healthy economy, prices should be stable, or even declining over time. Instead, our current monetary system inflates the dollar constantly. There's no avoiding it—it's an inherent feature of our 'modern' economy.

And as the dollar supply goes up, gold prices are driven up even further. That's why inflation alone is a strong argument for \$2,500 gold.

As we end this chapter, you might be wondering something. We saw how all money is created by the Fed system (either the Fed itself or the banks) in the form of loans. As the loans are repaid, the new money is re-absorbed by the system and disappears.

However, these loans have to be repaid with interest. Where does the money come from to pay the interest?

The answer to this question brings up another reason why gold is going to \$2,500. And we'll discuss it in the next chapter.