Banks Profit from Near-zero Interest Rates: Another Reason for States to Own Their Banks

Avoiding Another Lehman-style Credit Collapse

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While individuals, businesses and governments suffer from a credit crisis created on Wall Street, the banks responsible for the crisis are tapping into nearly-interest-free credit lines and using the money to speculate or to make commercial loans at much higher rates. By forming their own banks, states too can tap into very low interest rates, and can buffer themselves from another Lehman-style credit collapse.

Keeping interest rates low is considered the first line of defense for central banks bent on easing the credit crisis and getting banks to lend again. The Federal Reserve's target for the federal funds rate — the overnight interest rate that banks charge each other – has been kept at a rock-bottom 0% to 0.25% ever since December 2008. A growing number of economists now think it could stay there well into 2011 or even 2012, prompted by fears that a spreading debt crisis in Europe could hurt a budding U.S. recovery.

Dirk van Dijk, writing for the investor website Zacks.com, explains what a good deal this is for the banks:

"Keeping short-term rates low . . . is particularly helpful to the big banks like Bank of America (BAC) and JPMorgan (JPM). Their raw material is short-term money, which is effectively free right now. They can borrow at 0.25% or less, and then turn around and invest those funds in, say, a 5-year T-note at 2.50%, locking in an almost risk-free profit of 2.25%. On big enough sums of money, this can be very profitable, and will help to recapitalize the banking system (provided they don't drain capital by paying it out in dividends or frittering it away in outrageous bonuses to their top executives)."

This can be very profitable indeed for the big Wall Street banks, but the purpose of the near-zero interest rates was supposed to be to get the banks to lend again. Instead, they are investing this virtually interest-free money in risk-free government bonds, on which we the taxpayers are paying 2.5% interest; or are using the money to engage in the same sort of unregulated speculation that nearly brought down the economy in 2008, or to buy up smaller local banks, or to pay "outrageous bonuses to their top executives." Even when banks do deign to use their nearly-interest-free funds to support loans, they do not pass these very low rates on to borrowers. The fed funds rate was lowered by 5% between August 2007 and December 2008; yet the 30 year fixed mortgage rate dropped less than 1%, from 6.75% to only about 6%.

Why Do Banks Need to Borrow? Because They Don't Really Have the Money They Lend

Dirk van Dijk writes that "short-term money" — meaning money borrowed short-term from other banks — is the "raw material" of the big banks. Why, you may ask, do banks need to borrow from each other? Don't they just take in money from their depositors and relend it?

The answer is no. Banks do not lend their depositors' money or their own money. As the Federal Reserve Bank of Dallas explains on its website:

"Banks actually create money when they lend it. Here's how it works: Most of a bank's loans are made to its own customers and are deposited in their checking accounts. Because the loan becomes a new deposit, just like a paycheck does, the bank . . . holds a small percentage of that new amount in reserve and again lends the remainder to someone else, repeating the money-creation process many times."

A bank simply advances bank credit created on its books. This credit becomes a deposit in the account of the borrower, who can write checks on it. The checks then get deposited in other banks and trade in the economy as what we all know as "money."

A bank can create as much money on its books as it can find creditworthy borrowers for, up to the limit of its capital requirement. The hitch comes when the checks drawn on these loans-turned-deposits are cleared, usually through the Federal Reserve. A bank with a 10% reserve requirement must keep 10% of its deposits either as "vault cash" or in a reserve account at the Fed, and when checks are cleared by the Fed, it is through this account. The effect is to make the bank short of reserves, which it can try to replenish by attracting back the customers of the bank where the credit was deposited. But as was explained by the Winterspeak blogging team:

"If bank A [the lending bank] fails to [attract new depositors], then it simply borrows the reserves it needs overnight from . . . bank B [the bank where the reserves wound up]. The overnight lending market is designed to do exactly this. Bank B, in this case, happens to have exactly the quantity of reserves bank A needs, and since reserves earn no interest, is happy to lend to bank A at the federal funds rate, which is the overnight interbank lending rate."

In effect, a bank can create money on its books, lend the money at interest (today about 4.7% on a fixed rate mortgage), then clear the outgoing check by borrowing back the money it just created, at a cost to the bank of only the very low fed funds rate (now .2%). The bank creates bank credit, lends it at 4.7%, then borrows it back at .2% to clear the outgoing checks, collecting 4.5% interest as its profit. The credit the bank has lent is not an asset it has labored to earn but is simply "the full faith and credit of the United States" – the credit of the people collectively. Yet the bank is allowed to pocket a hefty interest spread on this credit-generating scheme; and that is assuming it lends at all, something that is happening less and less these days, since bankers find it safer and more lucrative to use their nearly interest-free credit lines to invest in risk-free government bonds at taxpayers' expense, engage in speculation, or pay themselves sizeable bonuses.

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The reason banks are highly dependent on loans from each other, then, is that they need these low-cost loans to keep the credit shell game going. This is particularly true for large Wall Street banks. Small banks get their funds mainly from customer deposits, and usually have more deposits than they can find creditworthy borrowers for. Large banks, on the other hand, generally lack sufficient deposits to fund their main business — dealing with large companies, governments, other financial institutions, and wealthy people. Most borrow the funds they need from other major lenders in the form of short term liabilities that must be continually rolled over.

That helps shed light on what really caused the credit crisis following the collapse of Lehman Brothers in September 2008. The Lehman bankruptcy triggered a run on the money markets, causing interbank lending rates to soar. The London interbank lending rate (LIBOR) normally adheres closely to official interest rate expectations (meaning, in the U.S., the targeted fed funds rate); but after Lehman went bankrupt, the LIBOR rate for short-term loans shot up to around 5%. Since the cost of borrowing the money to cover their loans was too high for banks to turn a profit, lending abruptly came to a halt.

Interest rates on variable rate mortgages and big corporate deals tend to be based on LIBOR rates, which are moving up again now, although the fed funds rate has not changed. LIBOR rates are moving up due to tensions arising from the possibility that Europe's sovereign debt crisis could turn into another global banking crisis.

This is just one of many reasons that states should consider following the model of North Dakota, the only state that currently owns its own bank. The state-owned Bank of North Dakota (BND) helped North Dakota escape the credit crisis. The BND has a very large and captive deposit base, since all of the revenues of the state are deposited in the bank by law, keeping the bank solvent regardless of what is happening in the interbank lending market. North Dakota is currently the only state not struggling with a budget deficit.

Nations could follow this model as well. A recent article in The Economist noted that the strong and stable publicly-owned banks of India, China and Brazil helped those countries weather the banking crisis afflicting most of the world in the last two years.

If You Can't Beat Them, Join Them

While the banks responsible for today's economic crisis are enjoying unprecedented benefits, state and local governments are forced to maintain very large and wasteful rainy day funds, even as they are slashing services to balance their budgets. They have to do this because they do not have the secure, nearly-interest-free credit lines available to private banks. Owning their own banks can allow local governments to avail themselves of the very low interest rates accessible to private banks, by giving them the same authority to create "bank credit" on their books that private banks have. North Dakota, which has had its own government-owned bank for over 90 years, not only is the only state to sport a budget surplus but has the lowest unemployment rate in the U.S. It evidently has no funding problems at all. Five other states currently have bills on their books to consider forming their own banks, and several others have discussed that option in their legislatures.

The Federal Reserve and the U.S. government have gone to extraordinary lengths to keep a corrupt banking system afloat, including buying toxic assets off their books and making credit available nearly interest-free, all in the name of turning the credit spigots back on on Main Street; but the banks have not kept their end of the bargain. In fact, they are just doing what their business models require of them – making the highest possible return for their shareholders. Publicly-owned banks operate on a different model: they must serve the community. Like China, India and Brazil, U.S. states would be well served to set up publicly-owned banks that could provide credit to the local economy when the private banking scheme fails.

Ellen Brown *developed her research skills as an attorney practicing civil litigation in Los Angeles. In Web of Debt, her latest of eleven books, she turns those skills to an analysis of the Federal Reserve and "the money trust." She shows how this private cartel has usurped the power to create money from the people themselves, and how we the people can get it back. Her websites are www.webofdebt.com, www.ellenbrown.com, and www.public-banking.com.*

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