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How California Could Turn its IOUs into Dollars

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California *has over $17 billion on deposit in banks that have refused to honor its IOUs, forcing legislators to accept crippling budget cuts. These austerity measures are unnecessary. If the state were to deposit its money in its own state-owned bank, it could have enough credit to solve its budget crisis with funds to spare.*

"We make money the old-fashioned way," said Art Rolnick, chief economist of the Minneapolis Federal Reserve. "We print it." That works for the federal government's central bank, but states are forbidden by the Constitution to issue "bills of credit," a term that has been interpreted to mean the state's own paper money. "Sacramento is not Washington," said California Governor Arnold Schwarzenegger in May. "We cannot print our own money." When legislators could not agree on how to solve the state's $26.3 billion budget deficit, the Governor therefore did the next best thing: he began paying the bills with IOUs ("I Owe You's," or promises to pay bearing interest).

The problem was that most banks declined to honor the IOUs, at least after July 24. "They said something about not wanting to enable the dysfunctional state legislature," observed a San Diego Union-Tribune staff writer, "which is kind of funny as the federal government has been enabling the dysfunctional financial sector for almost a year."

On July 21, California legislators were strong-armed into a tentative agreement on budget cuts, a forced move that was called "painful" by the Speaker of the Assembly and "devastating" by the executive director of the California State Association of Counties. The cuts involve more job losses, more bleeding of school funds, more closing of facilities. Worse, they will not solve the budget crisis long-term. The state's economy is expected to continue to deteriorate along with its revenues. But without banks to honor the state's IOUs, California has no time to negotiate or explore alternatives. There is no "quick fix," says UCLA Professor Daniel Mitchell.

Or is there?

More Than One Way to Solve a Budget Crisis

Among the banks rejecting California's IOUs are six of particular interest: Citibank, Union Bank, Bank of America, Wells Fargo, U.S. Bank, and Westamerica Bank. These banks are interesting because they are *six of the seven depository banks in which the state of California currently deposits its money*. (The seventh is Bank of the West, which loyally said it would accept the IOUs indefinitely.)

Banks operate under federal or state charters that grant them special rights and privileges. Chartered banks are endowed with a gift that keeps on giving: they can "leverage" the value of their deposits into anywhere from ten to thirty times that sum in interest-bearing loans. This "multiplier effect" is attested to by many authorities, including President Obama himself. He said in a speech at Georgetown University on April 14:

"[A]lthough there are a lot of Americans who understandably think that government money would be better spent going directly to families and businesses instead of banks – 'where's our bailout?,' they ask – the truth is that a dollar of capital in a bank can actually result in eight or ten dollars of loans to families and businesses, a multiplier effect that can ultimately lead to a faster pace of economic growth."

The website of the Federal Reserve Bank of Dallas explains:

"*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."

Combine this with another interesting fact: according to the California Treasurer's report, as of May 2009 the state had aggregate deposits and investments exceeding $55 billion. Of this sum, $1.1 billion was held in demand deposit accounts (non-interest-bearing accounts allowing unlimited deposits and withdrawals) and $16.5 billion was in NOW accounts (interest-bearing accounts allowing unlimited deposits and withdrawals). According to the Treasurer's office, the non-interest-bearing demand deposits are held at the seven depository banks named earlier, while the NOW accounts are held at Citibank and Union Bank. Applying a "multiplier effect" of ten to the total sum on deposit at these seven banks ($17.6 billion), the banks collectively have the ability to make *$176 billion* in loans. At 5%, $176 billion can generate $8.8 billion in interest for the banks.

Rather than showing their gratitude by reciprocating, however, six of the seven depository banks have refused to honor California's IOUs. Worse, three of these six actually received federal bailout money from the taxpayers, something that was supposedly done to keep credit flowing to the states and their citizens. Citibank got $45 billion in bailout money, Wells Fargo got $25 billion, and Bank of America got $45 billion, not to mention guarantees of $300 billion for Citibank and $118 billion for Bank of America. When Governor Schwarzenegger asked for a loan guarantee for a mere $6 billion to bolster California's credit rating, on the other hand, he was turned down. Californians compose one-eighth of the nation's population.

When the state's appeal for aid was rejected by the banks, California State Treasurer Bill Lockyer said he was "disappointed." He and other state leaders should show their disappointment with their feet. California could pull its deposits out of those depository banks refusing its IOUs and put them instead in its own state-owned bank, following the lead of North Dakota, which now has the only state-owned bank in the country. Set up in 1919 to escape Wall Street predators, the Bank of North Dakota has been generating low-interest credit for the state and its residents for nearly a century. North Dakota is one of only two states (along with Montana) currently able to meet their budgets.

A state-owned bank could be fast-tracked into operation in a matter of weeks. With over $17 billion available to deposit in its own bank, California could create $170 billion or more in credit — enough not only to meet its budget shortfall but to fund many other much-needed projects; and rather than feeding an ungrateful Wall Street, the bank's profits would return to the state and its people.

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