

# How to Resolve the Credit Crisis: Credit Where Credit is Due

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Letter to the bank - Dear Sirs, In light of recent developments, when you returned my check marked "insufficient funds," were you referring to my funds or yours?

Economist John Kenneth Galbraith famously said, "The process by which banks create money is so simple that the mind is repelled." If banks can create money, why are we suffering from a "credit crunch"? Why can't banks create all the money they can find borrowers for? Last fall, Congress committed an unprecedented \$700 billion in taxpayer money to reversing the credit crisis, and the Federal Reserve has already fanned that into \$8.5 trillion in loans and commitments.<sup>1</sup> But the bank bailout has proven to be no more than a boondoggle for a handful of lucky Wall Street banks, without getting credit flowing again.

To understand the real cause of the credit crisis and how it can be reversed, we first need to understand credit itself - what it is, where it comes from, and what the real tourniquet is that has limited its flow. Banks actually *create* credit; and if private banks can do it, so could public banks or public treasuries. The crisis is not one of "liquidity" but of "solvency." It has been caused, not by the banks' inability to get credit (something they can create with accounting entries), but by their inability to meet the capital requirement imposed by the Bank for International Settlements, the private foreign head of the international banking system. That inability, in turn, has been caused by the derivatives virus; and only a few big banks are seriously infected with it. By bailing out these big banks, the government is actually spreading the virus by furnishing the funds for them to take over smaller regional banks.

A more effective alternative than trying to patch up the hopelessly imperiled derivatives positions of these few Wall Street banks would be to simply create another credit system with a pristine set of books. We don't need to fix the Wall Street disease; we can bypass the whole problem and create a new, healthy, parallel system. A network of *public* banks (federal and state) could create "credit" just as private banks do now. This credit could be extended at low interest rates to consumers and at very low interest to local governments, drastically reducing the cost of public projects by reducing the cost of funding them.

That is not a radical proposal. *It is what private banks themselves do every day.* But bankers will dispute it, and most people have trouble believing it. So to make a compelling case for this solution, the first thing that needs to be established is that . . .

## **Banks Create the Money They Lend**

Bankers will tell you that they do not create money. At a 10% reserve requirement, they simply lend out 90% of their deposits. The catch is that their “deposits” include the money they have written into their customers’ accounts as loans. That is how loans are made: numbers are simply written into the accounts of borrowers, as many reputable authorities have attested. Here are two of them, dating back to when officials were either more aware of what was going on or more open about it:

“[W]hen a bank makes a loan, it simply adds to the borrower’s deposit account in the bank by the amount of the loan. *The money is not taken from anyone else’s deposit; it was not previously paid in to the bank by anyone. It’s new money, created by the bank for the use of the borrower.*”

- Robert B. Anderson, Treasury Secretary under Eisenhower, in an interview

reported in the August 31, 1959 issue of U.S. News and World Report

“Do private banks issue money today? Yes. Although banks no longer have the right to issue bank notes, they can create money in the form of bank deposits when they lend money to businesses, or buy securities. . . . The important thing to remember is that when banks lend money *they don’t necessarily take it from anyone else to lend. Thus they ‘create’ it.*”

- Congressman Wright Patman, Money Facts (House Committee on Banking and Currency, 1964)

The process by which banks create money was detailed in a revealing booklet put out by the Chicago Federal Reserve titled Modern Money Mechanics.<sup>2</sup> The booklet was periodically revised until 1992, when it had reached 50 pages long. It is written in somewhat difficult prose, but here are a few relevant passages:

*“The actual process of money creation takes place primarily in banks.” [p3]*

Translation: banks create money.

*“In the absence of legal reserve requirements, banks can build up deposits by increasing loans and investments so long as they keep enough currency on hand to redeem whatever amounts the holders of deposits want to convert into currency.” [p3]*

Translation: banks can create as much money as they want by writing loans into their borrowers’ accounts, limited only by (a) legal reserve requirements (money that must be held in reserve - traditionally about 10% of outstanding deposits and loans) or (b) the amount of money they will need to keep on hand to pay any depositors who might come for their money (also traditionally about 10%).

*“Banks may increase the balances in their reserve accounts by depositing checks and proceeds from electronic funds transfers as well as currency.” [p4]*

Translation: the “reserves” that count toward the reserve requirement include currency, deposited checks, and electronic funds transfers. (Note that the “deposits” created as loans are excluded from this list of allowable reserves: the bank cannot just keep bootstrapping loans on top of loans but must have money from external sources backing up its liabilities equal to about 10% of its loans and deposits.)

*“The money-creation process takes place principally through transaction accounts [accounts that can be drawn on without restriction].” [p2]*

*“ With a uniform 10 percent reserve requirement, a \$1 increase in reserves would support \$10 of additional transaction accounts.” [p49]*

Translation: \$1 deposited by a customer can be fanned into \$10 in loans.

*“In the real world, a bank’s lending is not normally constrained by the amount of excess reserves it has at any given moment. Rather, loans are made, or not made, depending on the bank’s credit policies and its expectations about its ability to obtain the funds necessary to pay its customers’ checks and maintain required reserves in a timely fashion.”*

Translation: In practice, banks issue loans without worrying too much about whether they have the reserves to cover them. If they come up short, they can just borrow them:

*“[Since] the individual bank does not know today precisely what its reserve position will be at the time the proceeds of today’s loans are paid out. . . . many banks turn to the money market – borrowing funds to cover deficits or lending temporary surpluses.” [p50]*

*“[A] bank may [also] borrow reserves temporarily from its Reserve Bank. . . .*

*[However], banks are discouraged from borrowing [Reserve Bank] adjustment credit too frequently or for extended time periods.” [p29]*

Translation: If the bank finds at the end of the accounting period that its reserves do not come to the required 10% of its outstanding loans and deposits, it can simply borrow the reserves it needs from the money market or its Federal Reserve Bank.

A 2002 article posted on the website of the Federal Reserve Bank of New York noted that today, few banks are constrained by reserve requirements at all:

*“Since the beginning of the last decade, required reserve balances have fallen dramatically. The decline stems in part from regulatory action: the Federal Reserve eliminated reserve requirements on large time deposits in 1990 and lowered the requirements on transaction accounts in 1992. But a far more important source of the decline in required reserves has been the growth of sweep accounts. In the most common form of sweeping, funds in bank customers’ retail checking accounts are shifted overnight into savings accounts exempt from reserve requirements and then returned to customers’ checking accounts the next business day. Largely as a result of this practice, today only 30 percent of banks are bound by a reserve balance requirement.”<sup>3</sup>*

Even without official reserve requirements, however, banks must keep enough money on hand to meet withdrawals or checks written against the accounts of their depositors; and

that generally means about 10% of outstanding deposits and loans, as moneylenders discovered centuries ago. But if the banks come up short, they can borrow this money from the money market or the Federal Reserve; and if the Fed comes up short, it can create new reserves.<sup>4</sup> So why the current credit crunch? What is limiting bank lending?

One answer is that borrowers are simply “tapped out” and not in a position to take out as many loans as they used to. When housing and the stock market crashed, consumers no longer had home or stock equity to borrow against.<sup>5</sup> But to the extent that the blockage is with the banks themselves, it is not caused by the reserve requirement. Something else is putting the squeeze on credit . . . .

### **The Real Tourniquet:**

#### **Capital Adequacy and the Mark-to-Market Rule**

What actually constrains bank lending is the capital adequacy requirement, something that is imposed not by our own central bank but by the Bank for International Settlements (BIS). Called “the central bankers’ central bank,” the BIS pulls the strings of the private international banking system from Basel, Switzerland.

How the capital requirement is determined is even more complicated than the reserve requirement, but it needs to be understood to understand why banks with the power to create money are going bankrupt. So here is a simplified version. A bank’s “capital” consists of its assets minus its liabilities. Under the capital adequacy rule imposed by the Basel Accords, assets are “risk-weighted,” with some being considered riskier than others. Ordinary loans have a “risk weighting” of 1. The capital adequacy rule requires that the ratio of a bank’s capital to its assets with a risk-weighting of 1 be at least 8%. That means the bank must have \$8 in capital for every \$100 in ordinary loans. Federal bonds have a risk-weighting of zero: they are considered to be as safe as dollars and don’t need any extra capital backing them. Mortgage loans (which are secured by real estate) have a risk weighting of .5. That means they need only \$4 of capital per \$100 of loans. Other bank exposures given risk weightings include such things as derivatives and foreign exchange contracts.<sup>6</sup> (Interestingly, the \$700 billion committed by Congress to bailing out the financial system is approximately 8% of the \$8.5 trillion the Fed has now promised in loans and commitments. Even the Federal Reserve evidently feels constrained by the BIS capital requirement.)

A very controversial accounting rule imposed on banks for their capital ratio calculations is the “mark to market” rule. This rule requires banks to revalue all of their assets each day as if the assets had to be sold that day. Capital calculations thus fluctuate with the market; and in today’s volatile market, all asset classes have plunged at the same time. Since assets get marked to market but liabilities don’t, a bank may suddenly find that its assets are insufficient to support its liabilities, rendering it insolvent and unable to make new loans. Banks have gotten around the capital adequacy requirement by reducing risk on their balance sheets with a form of private bet known as “derivatives.” At least, they thought they had gotten around the rule. But this unregulated form of insurance proved to be based on faulty mathematical models. (See Ellen Brown, “Credit Default Swaps: Derivative Disaster Du Jour,” and “It’s the Derivatives, Stupid!,” [www.webofdebt.com/articles](http://www.webofdebt.com/articles).)

“Credit default swaps” (CDS) are a form of derivative widely sold as insurance against

default. When AIG, the world's largest insurance company, ventured into CDS in the late 1990s, the presumption was that "housing always goes up" and that the risk of default was so remote that selling "credit protection" was virtually "free money".<sup>7</sup> But this free money turned into a serious liability to the protection sellers when the "remote" actually happened and a flood of defaults struck. The value of the derivatives protecting securitized mortgages became so questionable that they were unmarketable at any price. Banks counting them as assets on their books then had to "mark them to market" effectively at zero, reducing the banks' capital below the levels called for in the Basel Accords and rendering the banks officially insolvent.

When AIG went broke in September 2008, banks heavily involved in derivatives faced double jeopardy: not only would they have to write down the derivative protection they had sold to others and counted as assets on their books, but they could no longer count on the derivative insurance they had bought to minimize the risk of default on their other assets. AIG got a massive bailout from the Fed in return for most of its equity, but even that bailout money is not expected to be enough to get it out of its derivative nightmare and keep it afloat.

Derivatives have introduced a lack of transparency into bank portfolios, creating fear and uncertainty on the part of lenders, depositors and investors alike. This uncertainty has prevented banks from raising capital by selling stock, or meeting reserve requirements by getting interbank loans; and it has discouraged investors from investing in the money market. Banks don't know whether the money they lend to each other will be repaid, since they don't have a clear view of the value of the assets carried on bank balance sheets. The result is a crisis of confidence: the players are all eying each other suspiciously and holding their cards close to the chest.

## **Going Local**

Fortunately, according to a recent study using the Treasury Department's own data, the banking crisis is not widespread but is limited to only "a few big, vocal banks."<sup>8</sup> The real credit problem lies with the financial institutions with significant derivative exposure, and most of this liability is carried by only a handful of Wall Street giants. In early 2008, outstanding derivatives on the books of U.S. banks exceeded \$180 trillion. However, \$90 trillion of this was carried on the books of JPMorgan Chase alone, while Citibank and Bank of America each had \$38 trillion on their books.<sup>9</sup> Needless to say, these are also the banks that are first in line for the Treasury's bailout money under the Troubled Asset Relief Program. Rather than excising the relatively contained derivative tumor, the Treasury and the Fed are feeding it with trillions in taxpayer money; and this money is being used, not to unfreeze credit by making loans, but to buy up smaller banks.<sup>10</sup> That means the derivative cancer, rather than being excised, is liable to spread.

We the people and our representatives in Congress have allowed Wall Street to call the shots because we think we are dependent on their credit system, but we aren't. There are other ways to get credit — ways that are fair, efficient, transparent, and don't encourage greed. Public credit could be generated by a system of *public* banks. Precedent for this solution is to be found in the state-owned Bank of North Dakota, which has been generating credit for North Dakota since 1919, keeping the state fiscally sound when other states are floundering. (See Ellen Brown, "Sustainable Government: Banking for a 'New' New Deal,"

webofdebt.com/articles, December 8, 2008.)

The credit crunch could be avoided by “going local” not just in the United States but around the world. Countries that have been seduced or coerced into funneling their productive assets into serving foreign markets and foreign investors could become self-sustaining, using their own credit and their own resources to feed and serve their own people. There is much more to be said on this subject, but it will be saved for future articles. Stay tuned.

**Ellen Brown** developed her research skills as an attorney practicing civil litigation in Los Angeles. In *Web of Debt*, her latest book, 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 earlier books focused on the pharmaceutical cartel that gets its power from “the money trust.” Her eleven books include *Forbidden Medicine*, *Nature’s Pharmacy* (co-authored with Dr. Lynne Walker), and *The Key to Ultimate Health* (co-authored with Dr. Richard Hansen). Her websites are [www.webofdebt.com](http://www.webofdebt.com) and [www.ellenbrown.com](http://www.ellenbrown.com).

## Notes

1 Kathleen Pender, “Government Bailout Hits \$8.5 Trillion,” San Francisco Chronicle (November 26, 2008).

2 Modern Money Mechanics: A Workbook on Bank Reserves and Deposit Expansion (Federal Reserve Bank of Chicago, Public Information Service, 1992, available at <http://www.rayservers.com/images/ModernMoneyMechanics.pdf>).

3 Paul Bennett, Savros Peristiani, “Are Reserve Requirements Still Binding?”, Economic Policy Review (May 2002).

4 Modern Money Mechanics, op. cit.

5 Joshua Holland, “Was the ‘Credit Crunch’ a Myth Used to Sell a Trillion-Dollar Scam?”, AlterNet (December 29, 2008).

6 “Capital Requirement,” Wikipedia.

7 Robert O’Harrow Jr., Brady Dennis, “Complex Deals Led to AIG’s Undoing,” Los Angeles Times (January 1, 2009).

8 J. Holland, op. cit.

9 Comptroller of the Currency, “OCC’s Quarterly Report on Bank Trading and Derivatives Activities Third Quarter 2008,” [www.occ.treas.gov](http://www.occ.treas.gov); “US Bank Derivative Exposure,” FDIC/IRA Bank Monitor, chart reproduced on The Big Picture (blog), August 2008.

10 Joe Nocera, “So When Will Banks Give Loans?”, New York Times (October 25, 2008).

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