Playing the Banking Game

How Cash Starved States can Create their Own Credit

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> "He that will not apply new remedies must expect new evils; for time is the greatest innovator." Francis Bacon

On February 19, 2009, California narrowly escaped bankruptcy, when Governor Arnold Schwarzenneger put on his Terminator hat and held the state senate in lockdown mode until they signed a very controversial budget.1 If the vote had failed, the state was going to be reduced to paying its employees in I.O.U.s. California avoided bankruptcy for the time being, but 46 of 50 states are insolvent and could be filing Chapter 9 bankruptcy proceedings in the next two years.2

One of the four states that is not insolvent is an unlikely candidate for the distinction – North Dakota. As Michigan management consultant Charles Fleetham observed last month in an article distributed to his local media:

"North Dakota is a sparsely populated state of less than 700,000, known for cold weather, isolated farmers and a hit movie – *Fargo.* Yet, for some reason it defies the real estate cliché of location, location, location. Since 2000, the state's GNP has grown 56%, personal income has grown 43%, and wages have grown 34%. This year the state has a budget surplus of $1.2 billion!"

What does the State of North Dakota have that other states don't? The answer seems to be: *its own bank*. In fact, North Dakota has the only state-owned bank in the nation. The state legislature established the Bank of North Dakota in 1919. Fleetham writes that the bank was set up to free farmers and small businessmen from the clutches of out-of-state bankers and railroad men. By law, the state must deposit all its funds in the bank, and the state guarantees its deposits. Three elected officials oversee the bank: the governor, the attorney general, and the commissioner of agriculture. The bank's stated mission is to deliver sound financial services that promote agriculture, commerce and industry in North Dakota. The bank operates as a bankers' bank, partnering with private banks to loan money to farmers, real estate developers, schools and small businesses. It loans money to students (over 184,000 outstanding loans), and it purchases municipal bonds from public institutions.

Still, you may ask, how does that solve the solvency problem? Isn't the state still limited to spending only the money it has? The answer is no. Certified, card-carrying bankers are allowed to do something nobody else can do: *they can create "credit" with accounting entries on their books*.

A License to Create Money

Under the "fractional reserve" lending system, banks are allowed to extend credit (create money as loans) in a sum equal to many times their deposit base. Congressman Jerry Voorhis, writing in 1973, explained it like this:

"[F]or every $1 or $1.50 which people – or the government – deposit in a bank, the banking system can create out of thin air and by the stroke of a pen some $10 of checkbook money or demand deposits. It can lend all that $10 into circulation at interest just so long as it has the $1 or a little more in reserve to back it up."3

That banks actually create money with accounting entries was confirmed in a revealing booklet published by the Chicago Federal Reserve titled Modern Money Mechanics.2 The booklet was periodically revised until 1992, when it had reached 50 pages long. On page 49 of the 1992 edition, it states:

"With a uniform 10 percent reserve requirement, a $1 increase in reserves would support $10 of additional transaction accounts [loans created as deposits in borrowers' accounts]."4

The 10 percent reserve requirement is now largely obsolete, in part because banks have figured out how to get around it with such devices as "overnight sweeps." What chiefly limits bank lending today is the 8 percent capital requirement imposed by the Bank for International Settlements, the head of the private global central banking system in Basel, Switzerland. With an 8 percent capital requirement, a state with its own bank could fan its revenues into 12.5 times their face value in loans (100 ÷ 8 = 12.5). And since the state would actually *own* the bank, it would not have to worry about shareholders or profits. It could lend to creditworthy borrowers at very low interest, perhaps limited only to a service charge covering its costs; and it could lend to itself or to its municipal governments at as low as *zero* percent interest. If these loans were rolled over indefinitely, the effect would be the same as creating new, debt-free money.

Dangerously inflationary? Not if the money were used to create new goods and services. Price inflation results only when "demand" (money) exceeds "supply" (goods and services). When they increase together, prices remain stable.

Today we are in a dangerous *de*flationary spiral, as lending has dried up and asset values have plummeted. The monopoly on the creation of money and credit by a private banking fraternity has resulted in a malfunctioning credit system and monetary collapse. Credit markets have been frozen by the wildly speculative derivatives gambles of a few big Wall Street banks, bets that not only destroyed those banks' balance sheets but are infecting the whole private banking system with toxic debris. To get out of this deflationary debt trap requires an injection of new, debt-free money into the economy, something that can best be done through a system of public banks dedicated to serving the public interest, administering credit as a public utility.

Some experts insist that we must tighten our belts and start saving again, in order to rebuild the "capital" necessary for functioning markets; but our markets actually functioned quite well so long as the credit system was working. We have the same real assets (raw materials, oil, technical knowledge, productive capacity, labor force, etc.) that we had before the crisis began. Our workers and factories are sitting idle because the private credit system has failed. A system of *public* credit could put them back to work again. The notion that "money" is something that has to be "saved" before it can be "borrowed" misconstrues the nature of money and credit. Credit is merely a legal agreement, a "monetization" of future proceeds, a promise to pay later from the fruits of the advance. Banks have created credit on their books for hundreds of years, and this system would have worked quite well had it not been for the enormous tribute siphoned off to private coffers in the form of interest. A public banking system could overcome that problem by returning the interest to the public purse. This is the sort of banking system that was pioneered in the colony of Pennsylvania, where it worked brilliantly well.

Restoring Michigan to Solvency

Among other advantages to a state of owning its own bank are the substantial sums it could save in interest. As Fleetham notes of his own ailing state of Michigan:

"According to recent financial reports (available online), the State of Michigan, the City of Detroit, the Detroit Water and Sewerage Department, the Wayne County Airport, the Detroit Public Schools, the University of Michigan, and Michigan State University pay over $800 million a year in interest on long term debt. If you add interest paid by Michigan cities, school districts, and public utilities, the cost to our taxpayers easily tops a billion a year. What does Wall Street do with our billion plus dollars? They decorate their offices like kings."

Interestingly, the projected state budget deficit for 2009 is also $1 billion. If Michigan did not have to pay over a billion dollars in interest to Wall Street, the budget could be balanced and the state could be restored to solvency. A state-owned bank could not only provide interest-free credit for the state but could actually generate revenues for it. Fleetham notes that in 2007, the Bank of North Dakota earned a net profit of $51 million on a loan volume of $2 billion. He comments:

"Last year, Michigan citizens paid over $5 billion dollars in personal income tax. With a state bank like North Dakota's we could reduce this burden, fund new businesses, and restore our crumbling water and sewer systems. And we don't have to feel sorry about Wall Street losing our business. They didn't 'earn' the money they lent us. They created it in computers and charged us interest to boot. Let's follow North Dakota's lead and get free from Wall Street's web."

Taking the Initiative in California

California could do this as well. Robert Ellis is a Tucson talk show host who once worked on Wall Street and has been involved in setting up several banks and financial institutions. In January of this year, he proposed in a letter to Governor Schwarzenegger that California could resolve its financial woes by setting up a bank on the model of the Bank of North Dakota. Ellis wrote to the governor:

"I admire your tenacity in dealing with California's financial problems. Your idea of using IOU's was ingenious but there is a better way. The State of California can charter its own bank and issue its own checks to all state employees . . . . It can also pay all its vendors, contracts and contractors through the bank . . . . Additionally, once the bank is operational, you can fund your own state projects and you determine the interest rate paid as opposed to being at the mercy of the banks you currently deal with or the interest rates the investment bankers make you pay to issue bonds. By doing this, you will put the state in control of its own destiny and make it the benefactor of its own money.

". . . What I am proposing is not new. It has been done by one other state in the nation [North Dakota]. Why should you continue to pay the banks for services and interest on loans when you can receive that interest for the benefit of the state of California? Wouldn't it be better if you could fund your own infrastructure projects without having to get the approval of independent banks or investment bankers? Additionally, you set the interest rate on your own projects. You can even set it at zero if you deem the project worthy enough."

Ellis offered his services in setting up the bank, which he thought could be chartered in a few short months. The Governor has not replied, but some pressure from constituents might encourage a response.

Failing that, there is the initiative and referendum process pioneered in California. It allows state laws to be proposed directly by the public, and the state's Constitution to be amended either by public petition (the "initiative") or by the legislature submitting a proposed constitutional amendment to the electorate (the "referendum"). The initiative is done by writing a proposed constitutional amendment or statute as a petition, which is submitted to the California Attorney General along with a submission fee, which was a modest $200 in 2004. The petition must be signed by registered voters amounting to 8% (for a constitutional amendment) or 5% (for a statute) of the number of people who voted in the most recent election for governor.5

As Gandhi said, "When the people lead, the leaders will follow." We the people can beat the Wall Street bankers at their own game, by moving our legislators to set up publicly-owned banks that create credit using the same banking principles that are accepted as standard and usual in the trade by bankers themselves.

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 and www.ellenbrown.com.

Notes

1. Anne Davies, "Lockdown Vote Saves California from Bankruptcy," theage.com.au (February 21, 2009).

2. John Mitchell, "46 of 50 States Could File Bankruptcy in 2009-2010," Freedom Arizona (January 30, 2009).

3. Jerry Voorhis, The Strange Case of Richard Milhous Nixon (1973), excerpted at http://www.sonic.net/~doretk/ArchiveARCHIVE/ECONOMICSPOLITICS/FEDERAL%20RESERVE/Jerry%20VoorhisFedReserve.html.

4. 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).

5. "California Ballot Proposition," Wikipedia.