

Why Banks Aren't Lending: The Silent Liquidity Squeeze

By [Ellen Brown](#)

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Why aren't banks lending to local businesses? The Fed's decision to pay interest on \$1.6 trillion in "excess" reserves is a chief suspect.

Where did all the jobs go? Small and medium-sized businesses are the major source of new job creation, and they are not hiring. Startup businesses, which contribute a fifth of the nation's new jobs, often can't even get off the ground. Why?

In a June 30 [article](#) in the Wall Street Journal titled "Smaller Businesses Seeking Loans Still Come Up Empty," Emily Maltby reported that business owners rank access to capital as the most important issue facing them today; and only 17% of smaller businesses said they were able to land needed bank financing. Businesses have to pay for workers and materials before they can get paid for the products they produce, and for that they need bank credit; but they are reporting that their credit lines are being cut. They are being pushed instead into credit card accounts that average 16 percent interest, more than double the rate of the average business loan. It is one of many changes in banking trends that have been very lucrative for Wall Street banks but are killing local businesses.

Why banks aren't lending is a matter of debate, but the Fed's decision to pay interest on bank reserves is high on the list of suspects. Bruce Bartlett, [writing in the Fiscal Times](#) in July 2010, observed:

Economists are divided on why banks are not lending, but increasingly are focusing on a Fed policy of paying interest on reserves — a policy that began, interestingly enough, on October 9, 2008, at almost exactly the moment when the financial crisis became acute. . .

Historically, the Fed paid banks nothing on required reserves. This was like a tax equivalent to the interest rate banks could have earned if they had been allowed to lend such funds. But in 2006, the Fed requested permission to pay interest on reserves because it believes that it would help control the money supply should inflation reappear.

. . . [M]any economists believe that the Fed has unwittingly encouraged banks to sit on their cash and not lend it by paying interest on reserves.

At one time, banks collected deposits from their own customers and stored them for their own liquidity needs, using them to back loans and clear outgoing checks. But today banks

typically borrow (or “buy”) liquidity, either from other banks, from the money market, or from the commercial paper market. The Fed’s payment of interest on reserves competes with all of these markets for ready-access short-term funds, creating a shortage of the liquidity that banks need to make loans.

By inhibiting interbank lending, the Fed appears to be creating a silent “liquidity squeeze” — the same sort of thing that brought on the banking crisis of September 2008. According to Jeff Hummel, associate professor of economics at San Jose State University, it could happen again. He [warns](#) that paying interest on reserves “may eventually rank with the Fed’s doubling of reserve requirements in the 1930s and bringing on the recession of 1937 within the midst of the Great Depression.”

The Travesty of the \$1.6 Trillion in “Excess Reserves”

The bank bailout and the Federal Reserve’s two “quantitative easing” programs were supposedly intended to keep credit flowing to the local economy; but despite trillions of dollars thrown at Wall Street banks, these programs have succeeded only in producing [mountains of “excess reserves”](#) that are now sitting idle in Federal Reserve bank accounts. A stunning \$1.6 trillion in excess reserves have accumulated since the collapse of Lehman Brothers on September 15, 2008.

The justification for TARP — the Trouble Asset Relief Program that subsidized the nation’s largest banks — was that it was necessary to unfreeze credit markets. The contention was that banks were refusing to lend to each other, cutting them off from the liquidity that was essential to the lending business. But an [MIT study](#) reported in September 2010 showed that immediately after the Lehman collapse, the interbank lending markets were actually working. They froze, not when Lehman died, but when the Fed started paying interest on excess reserves in October 2008. According to the study, as [summarized](#) in The Daily Bail:

. . . [T]he NY Fed’s own data show that interbank lending during the period from September to November did not “freeze,” collapse, melt down or anything else. In fact, every single day throughout this period, hundreds of billions were borrowed and paid back. The decline in daily interbank lending came only when the Fed ballooned its balance sheet and started paying interest on excess reserves.

On October 9, 2008, the Fed began [paying interest](#), not just on required bank reserves (amounting to 10% of deposits for larger banks), but on “excess” reserves. Reserve balances immediately shot up, and they have been going up almost vertically ever since.

By March 2011, [interbank loans outstanding](#) were only one-third their level in May 2008, before the banking crisis hit. And on June 29, 2011, the Fed reported [excess reserves](#) of nearly \$1.57 trillion - 20 times what the banks needed to satisfy their reserve requirements.

Why Pay Interest on Reserves?

[Why the Fed decided to pay interest](#) on reserves is a complicated question, but it was

evidently a desperate attempt to keep control of “monetary policy.” The Fed theoretically controls the money supply by controlling the Fed funds rate. This hasn’t worked very well in practice, but neither has anything else, and the Fed is apparently determined to hang onto this last arrow in its regulatory quiver.

In an effort to salvage a comatose credit market after the Lehman collapse, the Fed set the target rate for Fed funds – the funds that banks borrow from each other — at an extremely low 0.25%. Paying interest on reserves at that rate was intended to ensure that the Fed funds rate did not fall below the target. The [reasoning](#) was that banks would not lend their reserves to other banks for less, since they could get a guaranteed 0.25% from the Fed. The medicine worked, but it had the adverse side effect of killing the Fed funds market, on which local lenders rely for their liquidity needs.

It has been argued that banks do not need to get funds from each other, since they are now awash in reserves; but these reserves are [not equally distributed](#). The 25 largest U.S. banks account for over half of aggregate reserves, with 21% of reserves held by just 3 banks; and the largest banks have [cut back](#) on small business lending by over 50%. Large Wall Street banks have more lucrative things to do with the very cheap credit made available by the Fed than to lend it to businesses and consumers, which has become a risky and expensive business with the imposition of higher capital requirements and tighter regulations.

In any case, as noted in an [earlier article](#), the excess reserves from the QE2 funds have accumulated in foreign rather than domestic banks. John Mason, Professor of Finance at Penn State University and a former senior economist at the Federal Reserve, wrote in a [June 27 blog](#) that despite QE2:

Cash assets at the smaller [U.S.] banks remained relatively flat Thus, the reserves the Fed was pumping into the banking system were not going into the smaller banks. . . .

[B]usiness loans continue to “tank” at the smaller banking institutions.

Local Business Lending Depends on Ready Access to Liquidity

Without access to the interbank lending market, local banks are reluctant to extend business credit lines. The reason was [explained](#) by economist Ronald McKinnon in a Wall Street Journal article in May:

Banks with good retail lending opportunities typically lend by opening credit lines to nonbank customers. But these credit lines are open-ended in the sense that the commercial borrower can choose when—and by how much—he will actually draw on his credit line. This creates uncertainty for the bank in not knowing what its future cash positions will be. An illiquid bank could be in trouble if its customers simultaneously decided to draw down their credit lines.

If the retail bank has easy access to the wholesale interbank market, its liquidity is much improved. To cover unexpected liquidity shortfalls, it can borrow from banks with excess reserves with little or no credit checks. But if the prevailing interbank lending rate is close to zero (as it is now), then large banks with surplus reserves become loath to part with them for a derisory yield. And smaller banks, which collectively are the biggest lenders to SMEs [small and medium-sized enterprises], cannot easily bid for funds at an interest rate

significantly above the prevailing interbank rate without inadvertently signaling that they might be in trouble. Indeed, counterparty risk in smaller banks remains substantial as almost 50 have failed so far this year.

The local banks could turn to the Fed's discount window for loans, but that too could [signal](#) that the banks were in trouble; and for weak banks, the Fed's discount window may be [closed](#). Further, the discount rate is triple the Fed funds rate.

As Warren Mosler, author of *The 7 Deadly Innocent Frauds of Economic Policy*, [points out](#), bank regulators have made matters worse by setting limits on the amount of "wholesale" funding small banks can do. That means they are limited in the amount of liquidity they can buy (e.g. in the form of CDs). A certain percentage of a bank's deposits must be "retail" deposits - the deposits of their own customers. This forces small banks to compete in a tight market for depositors, driving up their cost of funds and making local lending unprofitable. Mosler maintains that the Fed could fix this problem by (a) lending Fed funds as needed to all member banks at the Fed funds rate, and (b) dropping the requirement that a percentage of bank funding be retail deposits.

Finding Alternatives to a Failed Banking Model

Paying interest on reserves was intended to prevent "inflation," but it is having the opposite effect, contracting the money and credit that are the lifeblood of a functioning economy. The whole economic model is wrong. The fear of price inflation has prevented governments from using their sovereign power to create money and credit to serve the needs of their national economies. Instead, they must cater to the interests of a private banking industry that profits from its monopoly power over those essential economic tools.

Whether by accident or design, federal policymakers still have not got it right. While we are waiting for them to figure it out, states can nurture and protect their own local economies with publicly-owned banks, on the model of the Bank of North Dakota (BND). Currently the nation's only state-owned bank, the BND services the liquidity needs of local banks and keeps credit flowing in the state. Other benefits to the local economy are detailed in a Demos report by Jason Judd and Heather McGhee titled "[Banking on America: How Main Street Partnership Banks Can Improve Local Economies](#)." They write:

Alone among states, North Dakota had the wherewithal to keep credit moving to small businesses when they needed it most. BND's business lending actually grew from 2007 to 2009 (the tightest months of the credit crisis) by 35 percent. . . . [L]oan amounts per capita for small banks in North Dakota are fully 175% higher than the U.S. average in the last five years, and its banks have stronger loan-to-asset ratios than comparable states like Wyoming, South Dakota and Montana.

[Fourteen states](#) have now initiated bills to establish state-owned banks or to study their feasibility. Besides serving local lending needs, state-owned banks can provide cash-strapped states with new revenues, obviating the need to raise taxes, slash services or sell off public assets.

Ellen Brown is an attorney and president of the Public Banking Institute, <http://PublicBankingInstitute.org>. In *Web of Debt*, her latest of eleven books, she shows how the power to create money has been usurped from the people, and how we can get it back. Her websites are <http://webofdebt.com> and <http://ellenbrown.com>.

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