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Dedicated to the independent study of monetary history, theory, and reform
"Over time, whoever controls the money system controls the nation."
Stephen Zarlenga, Director

The American Money Scene Bulletin 5

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Dear Friends,

As you know the states are in terrible financial condition, cutting back on necessary programs, laying off people and raising taxes. This has been the case for several years, and thanks to the banking crisis has reached horrific levels in some states. This is the time - *an opportunity to push for real reform*, such as the American Monetary Act. But instead, ill advised suggestions have recently been circulated on the internet that the states go into the banking business to solve or lessen this problem. The American Monetary Institute concludes that these suggestions, though they may be for well meaning purposes, are bad ideas for a lot of reasons as described below. People involved in real monetary reform understand that the private creation of money through what amounts to a fractional reserve accounting system is at the heart of the monetary problem which has plagued humanity and has now brought down the world economy. That vicious system by which money is created in our society must be reformed, not imitated. But there is no reform whatever in the proposal for states to enter the banking business.

It would also distract lawmakers from facing the facts about the national reforms that are needed to solve this crisis and institute a money system grounded in justice, which will operate to promote the general welfare. It would even sanction and endorse the present fractional reserve banking system, the source of the problem. That system requires condemnation and structural reform, not endorsements! We now have a blog at the end of this article below, so that you may record and post your reactions to Mr. Walton's research.
Sincerely,

Stephen Zarlenga
Director, AMI

Why States Going into the Banking Business Would be a Distraction, not a Solution to their Fiscal Problem

by Jamie Walton, AMI researcher

"We may not be able to stop them, but we can join them. We the people need to play the bankers' game ourselves."[1] – that was written by one of the promoters of the notion that the state governments should go into the fractional reserve banking business to beat Wall Street at its own game and solve their fiscal problems.

What an insult to humanity! How about a dose of morality and common sense. Isn't that like saying: "We're victims of organized financial crime, so lets join the criminals!"

Trying to beat Wall Street at its own game is obviously not the answer. As Albert Einstein once said, "We can't solve problems by using the same kind of thinking we used when we created them."

Forty-eight States currently have budget deficits and many are sharply cutting services to try to close 'fiscal' gaps opening up to an average 24% by 2010.

Some attention has recently been given to the idea that State governments can get out of their fiscal problems by setting up their own banks. This is mainly a distraction away from genuine reform of the system, as encapsulated in the proposed draft **American Monetary Act** (more about that below).

The argument being put forward is that State governments can increase their revenues without increasing taxes by collecting profits from State-run banks. The proposal suggests that State governments go into the banking business and "fan" their deposits into 10 or 12 times as much in loans, using 'fractional reserve' or 'capital adequacy' rules, to cover fiscal gaps with bank profits.

This is a foolish suggestion, for several reasons.

1. You don't solve a problem with more of the problem.

This scheme for states to go into the banking business would only 'serve to protect' the *status quo*. The 'proposal' completely fails to confront the main problem identified by all serious monetary reforms: 'fractional reserve' banking. Instead, it actually endorses and sanctions this vicious and destructive process, by suggesting that State governments engage in it – it's immoral!

2. What the promoters describe is not how banking operates.

No single bank can multiply its deposits by 10 or 12 times in loans, they can only make loans (or purchases of securities, e.g. bonds) up *against* 90-95% of their deposits; these loans *create* new deposits, which, when spent, are most likely transferred to other banks; then receiving banks can again make new loans up to 90-95% of their deposits, and so on. This 'process' is repeated indefinitely, in ever-decreasing increments, and the *effect* over time is that the banking system as a whole multiplies those initial deposits by 10 or 12 times. The only reason some progressives might be considering this proposal is they don't understand how fractional reserves work.

This process is carried on at great cost to the community as a whole, because every new loan (or new security purchase) is additional interest-bearing debt.

As presently operated, banks can be viewed as debt factories; they primarily create debt and only create the bulk of our money supply as a debt byproduct. Banks make profits and stay in business by putting the community as a whole into more debt than it can repay in any given time. This results in a net claim against the community going into the future. While some profits are paid to shareholders as dividends, this is only a small percentage of the debt created. If a bank was State-owned, the 'shareholders' would *nominally* be the people of the community, but any profits would still be based on the indebtedness of the community. That's the inevitable outcome, no matter who owns a bank, because the same rules apply to all banks in the banking system.

But; the question is not *who* should be the beneficiaries of perpetual claims against the community, the question is should *anyone* be the beneficiaries of perpetual claims against the community – why place ourselves forever on a treadmill just to have what we've already got? It makes no sense.

3. The problem is being misidentified as interest, when the problem is debt.

Proponents of the scheme are alleging that interest collected by "private" banks is kept out of circulation and is therefore not available to repay loans the bank have made. But this is not true. Most, if not all,

interest re-enters the system in some way at some time (e.g. as expenses, dividends, investments, etc.). This is not the problem. The problem is almost all of our money is created with a debt attached; it is 'borrowed into existence' from banks, who create it when we have to borrow it.

As our economy grows, we need new money, but almost all of the new money is presently created with interest-bearing debt, so almost every new dollar has more than a dollar owing on it – so it has to 'earn' more than a dollar and pay it all back to banks (who never had it in the first place). Who owns and runs any particular bank makes little or no difference because the debt-based money-creating banking system will still *own* and *run* us, on a treadmill.

Money doesn't have to be created like this; coins aren't, they're just created as money, with no debt attached; when they're issued, it's revenue for the U.S. government, saving taxpayers $$$. All money can be created this way. And; if we don't start with any debt, then we don't start with any interest either.

With that in mind, let's look again at the States' fiscal crisis.

State governments receive money from the community for the provision of public services and the support of volunteer services. These are generally things that are needed in the community which aren't commercial in nature, they're not the types of things that it's either possible or desirable to make a profit on (e.g. rape crisis centers, battered women's refuges, assisted housing for people with physical/mental impairments, respite care for caregivers, etc.).

Non-commercial services needed in the community couldn't exist without being paid for straight out, because providers can't borrow and then generate income to repay loans, that's not how they work (if they could do that, they'd be doing it already) – they need money that doesn't have to be paid back.

Diverting public resources away from desperately needed services toward a commercial venture would only make things worse. The effect on the ground could lead to the commercialization of services intended for the relief of poverty, disability, pain, suffering and misery; by forcing service providers to also be profit makers (e.g. commercialized prisons); or reverting to relying on the whims of charity. If neither of these 'choices' worked-out (which history shows, they generally don't), the community services essential for any viably functioning civil society might disappear altogether, and then "there goes the neighborhood" – social disintegration is a slippery slope, for *everyone*.

This is a very serious situation – it's no time to be playing games.

In addition to these defining moral questions, there are also some more technical reasons why they won't automatically work as suggested.

1. No bank's an island – they're all in it together.

A bank can only lend out what it can expect to receive back, not only from its borrowers in the long term, but also from all other banks through the clearing process in the very short term, i.e. usually overnight. Even if a State-run bank could attract other banks to have accounts with it and/or require its employees and suppliers to have accounts with it, the other banks would have to call in their loans by 10 or 12 times the amounts transferred (so there'd be no net gain in loans available). Of course, at some stage, all of its depositors would need to spend their money with people having accounts at other banks, so sooner or later its reserves would drain back to other banks and it would then have to call in its loans by 10 or 12 times as much. In any case, no bank can lend more than the prevailing level of lending of all other banks; every bank has to move in step with every other bank, otherwise it would soon sustain an adverse net balance through the clearing process and drain all its reserves to the other banks. It's a complete error that

any bank can just go ahead and multiply it's 'reserves' or 'capital' by 10 or 12 times in loans. If the other banks aren't lending, a State-run bank wouldn't be able to lend either.

2. Don't be fooled by what's happening in a low-population State.

North Dakota has about 700,000 people, a strong community spirit based on farming in difficult conditions, and significant oil revenues. The model being presented is the Bank of North Dakota, which provides support services to some other banks in its area.[2] But this arrangement won't automatically translate to other States, as the banks in other States may not wish to engage in it, and requiring them to could be very unpopular. This could lead to significant risks to taxpayers. In 1931, the Government Savings Bank of New South Wales (a federated State of Australia), at that time the 2nd largest savings bank in the British Empire, was closed down by a run caused by a series of 'scare' stories put out in the media as part of a 'political' attack.[3] If a similar action were possible against a State-run bank today, taxpayers might be called upon to pay for the aftermath (e.g. the Bank of North Dakota is not FDIC-insured(!), and is instead guaranteed by the State Government itself).

3. The promised golden goose may prove to be a noose.

What may look like a boost for taxpayers could end up being a ball-and-chain. For instance; where are States already in deficit going to get the money to set up a bank? As the President of the Bank of North Dakota, Eric Hardmeyer, explains (in the article cited above), to avoid a drain on existing deposits from other banks, and the consequent contraction in loans, a State government would probably have to issue bonds to raise the capital needed to set up a State-run bank.[4] Yet more debt bondage at a time like this may be more than the State's taxpayers can bear. In any case, a new bank would be as much of a burden on the community as any other bank. We would have the ridiculous situation of the people, as taxpayers, being put further into debt to build a debt factory to put the people, as the community, even further into debt.

4. States shouldn't gamble taxpayer's money on risky business.

The actual balances of State government bank accounts aren't huge, and they don't grow, because they're always being spent – that's what they're for. The actual profit *margins* banks make on their funds under management are generally modest, so any returns from a relatively small loan portfolio, after deducting operating expenses and re-investment in the business, wouldn't be anywhere near the amount required to fix the current fiscal shortfalls of the State governments. For example, in recent years the Bank of North Dakota has transferred between about a third to a half of its net income to the State coffers; ~$25 million in 2007, ~$20 million in 2008.[5] The total budget for the State Government for the 2007-2009 fiscal period is **$6.5 billion**.[6] A State law requires the bank to pay $60 million to the general fund over the same period – a contribution of less than 1% to the State budget. Meanwhile, State governments face *average* budget shortfalls of 24% for 2010 - so the numbers just don't stack up.[7] Weighing the pros and cons; relatively low potential returns compared to potential high risks (e.g. the concerted aggressive actions of other banks); it's not a very good bet.

5. States would be better-off using their clout with the banks.

A more prudent course of action would be for State governments to negotiate more favorable contracts for their banking business with one or more banks. This would involve much less cost and trouble (e.g. recruiting competent staff and administering a new enterprise) than trying to set up a bank, especially when public services are being cut. The banks need those deposits – they'll do anything to keep them (even if they don't like to admit it).

6. We don't need any more diversions.

We citizens have only so much energy and time to devote to changing our world for the better. Diverting good people into nonsense condemns us to continue suffering unnecessarily. This time of crisis must be used for real reform, not diversions.

So what is the solution?

It's the monetary system which must be changed to end the fiscal crisis, and State governments cannot do this – it's a matter for the Federal Government.

Under present constitutional and legal conventions, the only institutions that can create money without debt are national treasuries and/or central banks. State governments within a federal nation cannot do this – the problem can only be solved at the national level.

Proposals promoting anything else would require a constitutional amendment, which is not necessary.

There are some additional specious arguments being made within these promotions claiming that the U.S. Constitution (Article I, Section 8, Clause 5) does not authorize the U.S. Congress to issue non-coin money, so implying that it authorizes the States (or the people) to issue non-coin money.[8] It most certainly does not. As Robert G. Natelson, in the Harvard Journal of Law and Public Policy, exhaustively and authoritatively determined, the term "coin" (with a lower-case "c") means to create money in any form, whereas the term "Coin" (with an upper-case "C") means coins.[9]

There's also a lot of misinterpretations in these same arguments regarding the term "Bills of Credit" in the U.S. Constitution (Article I, Section 10, Clause 1) and "bills of credit" in other contexts, and the terms "Tender" and "Coin" (again). These misinterpretations lead to some ridiculous assertions like stating that: "The States violate the [U.S.] Constitution every day … to pay their debts … since gold and silver coins are no longer in general circulation."[10]

All of these spurious 'ideas' only serve as distractions during a time of crisis.

We have a big problem in our economy and society today: too much debt. Banking cannot solve this problem because banking produces debt, which is the problem. It's incredible that even now the delusion of borrowing ourselves out of debt is still seen as a solution, by ***anyone***, let alone so-called reformers. We're in a deep hole because we listened to cheerleaders yelling "keep on digging" without thinking. We cannot afford to keep doing this any more.

Proposing to get governments involved in banking is the complete opposite of a solution, because it keeps the problem in place.

As American Monetary Institute Chapter Leader, Dick Distelhorst, says:

"We don't want to put the government into the banking business – we want to get the banks out of the money creation business!" – Dick Distelhorst

The correct solution to the crisis was presented in Stephen Zarlenga's speech at the U.S. Treasury in December, 2003, titled "Solution to the States' fiscal crisis" (read it at www.monetary.org). That solution has become the proposed American Monetary Act. In California, Governor Schwarzenegger has had a

copy of *The Lost Science of Money* (the historical research which led to the solution) on his bookshelves since the spring of 2004.

Historical experience has taught us what we need to do:

1. Put the Federal Reserve System into the U.S. Treasury.

2. Stop the banking system creating any part of the money supply.

3. Create new money ***as needed*** by spending it on public infrastructure, including human infrastructure, e.g. education and health care.

These 3 elements must all be done together, and are all in draft legislative form as the proposed **American Monetary Act** (read it here: http://www.monetary.org/amacolorpamphlet.pdf).

The correct action is for Congress to fulfil its constitutional responsibilities to furnish the nation with its money by making the American Monetary Act law.

The correct action for the States is to insist on this Federal action!

Genuine monetary reform is the solution to the nation's fiscal problems, and that can only be achieved at the national level.
The American Monetary Institute is sponsoring the 5th annual Monetary Reform Conference at Roosevelt University in Chicago, September 24-27, 2009, to bring together the best minds to get done what has to be done.

Jamie R. Walton

Notes:

1. "The Public Option in Banking: How We Can Beat Wall Street at Its Own Game" ", Hodgson Brown, Ellen, J.D. Web of Debt (website), August 5, 2009.

2&4. "How the Nation's Only State-Owned Bank Became the Envy of Wall Street", Harkinson, Josh. Mother Jones, March 27, 2009.

3. "NSW Savings Bank Board Official Announcement: Protection To Depositors", The Age, April 23, 1931.

5. Bank of North Dakota 2008 Annual Report: Independent Auditor's Report, p. 4.

6. State of North Dakota: 2009-2011 Executive Budget Summary, p. 3.

7. "New Fiscal Year Brings No Relief From Unprecedented State Budget Problems", Lav, Iris J. and McNichol, Elizabeth. Center on Budget and Policy Priorities (website), updated August 12, 2009.

8&10. "Another Way Around the Credit Crisis: Minnesota Bill would authorize State Banks to "monetize" productivity", Hodgson Brown, Ellen, J.D. Web of Debt (website), March 23, 2008.

9. "Paper Money and the Original Understanding of the Coinage Clause", Natelson, Robert G. Harvard Journal of Law and Public Policy, July 1, 2008.