California's Empty Wallet: Turning Crisis into Opportunity

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California State Controller John Chiang has warned that without a balanced budget in place by July 1, he will begin using IOUs to pay most of the state's bills. On June 25, California Governor Arnold Schwarzenegger rejected a plan that would save the state $3 billion by cutting school spending, saying he would rather see the state issue IOUs than delay the funding problem with a piecemeal approach. The state's total budget deficit is $24.3 billion.

Meanwhile, other funding doors are slamming closed. The Obama administration has said it will not use federal stimulus money to prop up California; and Fitch Ratings, a bond rating agency, announced that it was downgrading the credit rating of the state, which already has the lowest in the nation. Once downgraded, California's rating is likely to fall below the minimum level legally required for most money market funds, forcing the funds to sell their California bonds. The result could be a cost of millions of additional dollars in higher interest rates for the state.

What to do? Perhaps California could take a lesson from the island state of Guernsey, located in the English Channel off the French Coast, which faced similar funding problems in the 19th century. Toby Birch, an asset manager who hails from there, tells the story in Gold News:

"As weary troops returned from a protracted foreign war [the Napoleonic Wars ending in 1815], they encountered a land racked with debt, high prices and a crumbling infrastructure, whose flood defenses were about to be overwhelmed . . . . While 1815 brought an end to the conflict on the battlefront, . . . severe austerity ensued on the home front. The application of the Gold Standard meant that loans issued over many years were then recalled to balance the ratio of money to precious metals. This led to economic gridlock as labor and materials were abundant, but much-needed projects could not be funded for want of cash.

"This led to a period of so-called 'poverty amongst plenty'. . . . The situation seemed insoluble; existing borrowing costs were consuming 80% of the island's revenues. What was already an unsustainable debt burden would need to be doubled to fund the two most essential infrastructure projects. This was when a committee of States members was formed . . . . The committee realized that if the Guernsey States issued their own notes to fund the project, rather than borrowing from an English bank, there would be no interest to pay. This would lead to substantial savings. Because as anyone with a mortgage should understand, the debtor ends up paying at least double the amount borrowed over the long-term."

To prevent an unwanted inflation of the money supply, the Guernsey States issued the notes with a date due, and on that date the bearer was paid in gold. The money came from rents on the finished infrastructure, supplemented with a tax on liquor. Birch goes on:

"The end result of the Guernsey Experiment was spectacular – new roads, sea defenses and public buildings were established, fostering widespread trade and prosperity. Full employment was achieved, no deficits resulted and prices were stable, all without a penny paid in interest. What started as a trial led to a string of construction projects, which still stand and function to this day. Money was used in its purest form: as a convenient mechanism for oiling the wheels of commerce and development."

Like Guernsey, California is facing "poverty amidst plenty." The state has the eighth largest economy in the world, larger than Russia's, Brazil's, Canada's and India's. It has the resources, labor, and technical expertise to make just about anything its citizens put their minds to. The only thing lacking is the *money* to do it. But money is merely a medium of exchange, a means of getting suppliers, laborers and customers together so that they can produce and exchange products.

As has been explained elsewhere, today money is simply *credit*. *All* of our money except coins is created by banks when they make loans. The current crisis stems from a credit freeze that began on Wall Street in the fall of 2007, when banks were required to revalue their assets due to a change in accounting rules, from "mark to fantasy" to "mark to market." Banks that were previously considered in good shape, with plenty of capital for making loans, suddenly came up short. Lending fell off, and so did the available money supply.

Just understanding the problem is enough to see the solution. If a private bank can create credit on its books, so can the mighty state of California. It merely needs to form its own bank. Under the "fractional reserve" lending system, banks are allowed to extend credit – or 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."

The 10 percent reserve requirement is now largely obsolete, in part because banks have figured out how to get around it. 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 on loans the bank made to the state, the state would ultimately get the interest, making the loans essentially interest-free.

Precedent for this approach is to be found in North Dakota, one of only three states currently able to meet its budget. North Dakota is not only solvent but now boasts the largest *surplus* it has ever had. The Bank of North Dakota, the only state-owned bank in the nation, was established by the legislature in 1919 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. The bank's surplus profits are returned to the state's coffers. The bank operates as a bankers' bank, partnering with private banks to loan money to farmers, real estate developers, schools and small businesses. It makes 1% loans to startup farms, has a thriving student loan business, and purchases municipal bonds from public institutions.

Looking at California's budget figures, projected state revenues for 2009 are $128 billion. At a reserve requirement of 10%, if California deposited all $128 billion in its own state-owned bank, it could issue $1.28 trillion in loans, far more than it would need to cover its $23 billion budget shortfall. To lend itself the money to cover the shortfall, it would need only $2.3 billion in

deposits and about $2 billion in capital (assuming an 8% capital requirement). What Sheldon Emry wrote of nations is equally true of states:

"It is as ridiculous for a nation to say to its citizens, 'You must consume less because we are short of money,' as it would be for an airline to say, 'Our planes are flying, but we cannot take you because we are short of tickets.'"

As a card-carrying member of the banking elite, California could create all the credit it needs to fund its operations, with money to spare.

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