Cut Wall Street Out! Own Your Own Bank

How States Can Finance Their Own Recovery

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Pouring money into the private banking system has only fixed the economy for bankers and the wealthy; it has not done much to address either the fundamental problem of unemployment or the debt trap so many Americans find themselves in.

President Obama's $787 billion stimulus plan has so far failed to halt the growth of unemployment: 2.7 million jobs have been lost since the stimulus plan began. California has lost 336,400 jobs. Arizona has lost 77,300. Michigan has lost 137,300. A total of 49 states and the District of Columbia have all reported net job losses.

In this dark firmament, however, one bright star shines. The sole state to actually gain jobs is an unlikely candidate for the distinction: North Dakota. North Dakota is also one of only two states expected to meet their budgets in 2010. (The other is Montana.) North Dakota is a sparsely populated state of less than 700,000 people, largely located in cold and isolated farming communities. Yet, since 2000, the state's GNP has grown 56 percent, personal income has grown 43 percent and wages have grown 34 percent. The state not only has no funding problems, but this year it has a budget surplus of $1.3 billion, the largest it has ever had.

Why is North Dakota doing so well, when other states are suffering the ravages of a deepening credit crisis? Its secret may be that it has its own credit machine. North Dakota is the only state in the Union to own its own bank. The Bank of North Dakota (BND) was established by the state legislature in 1919, specifically to free farmers and small businessmen from the clutches of out-of-state bankers and railroad men. The bank's stated mission is to deliver sound financial services that promote agriculture, commerce and industry in North Dakota.

The Advantages of Owning Your Own Bank

So, how does owning a bank solve the state's funding problems? Isn't the state still limited to the money it has? The answer is no. Chartered banks are allowed to do something nobody else can do: They can create credit on their books simply with accounting entries, using the magic of "fractional reserve" lending. As the Federal Reserve Bank of Dallas explains on its web site:

"Banks actually create money when they lend it. Here's how it works: Most of a bank's loans are made to its own customers and are deposited in their checking accounts. Because the loan becomes a new deposit, just like a paycheck does, the bank … holds a small percentage of that new amount in reserve and again lends the remainder to someone else, repeating the money-creation process many times."

How many times? President Obama puts this “multiplier effect” at eight to ten. In a speech on April 14, he said:

“[A]lthough there are a lot of Americans who understandably think that government money would be better spent going directly to families and businesses instead of banks – ‘where’s our bailout?,’ they ask – the truth is that a dollar of capital in a bank can actually result in eight or ten dollars of loans to families and businesses, a multiplier effect that can ultimately lead to a faster pace of economic growth.”

It can, but it hasn’t recently, because private banks are limited by bank capital requirements and by their for-profit business models. And that is where a state-owned bank has enormous advantages: States own huge amounts of capital, and they can think farther ahead that their quarterly profit statements, allowing them to take long-term risks. Their asset bases are not marred by oversized salaries and bonuses; they have no shareholders expecting a sizable cut, and they have not marred their books with bad derivatives bets, unmarketable collateralized debt obligations and mark-to-market accounting problems.

The Bank of North Dakota (BND) is set up as a dba: “the State of North Dakota doing business as the Bank of North Dakota.” Technically, that makes the capital of the state the capital of the bank. Projecting the possibilities of this arrangement to California, the State of California owns about $200 billion in real estate, has $62 billion in various investments and has $128 billion in projected 2009 revenues. Leveraged by a factor of eight, that capital base could support nearly $4 trillion in loans.

To get a bank charter, specific investments would probably need to be earmarked by the state as startup capital; but the startup capital required for a typical California bank is only about $20 million. This is small potatoes for the world’s eighth largest economy, and the money would not actually be “spent.” It would just become bank equity, transmuting from one form of investment into another – and a lucrative investment at that. In the case of the BND, the bank’s return on equity is about 25 percent. It pays a hefty dividend to the state, which is expected to exceed $60 million this year. In the last decade, the BND has turned back a third of a billion dollars to the state’s general fund, offsetting taxes. California could do substantially better than that. California pays $5 billion annually just in interest on its debt. If it had its own bank, the bank could refinance its debt and return that $5 billion to the state’s coffers; and it would make substantially more on money lent out.

Besides capital, a bank needs “reserves,” which it gets from deposits. For the BND, this too is no problem, since it has a captive deposit base. By law, the state and all its agencies must deposit their funds in the bank, which pays a competitive interest rate to the state treasurer. The bank also accepts deposits from other entities. These copious deposits can then be plowed back into the state in the form of loans.

Public Banking on the Central Bank Model

The BND’s populist organizers originally conceived of the bank as a credit union-like institution that would free farmers from predatory lenders, but conservative interests later took control and suppressed these commercial lending functions. The BND is now chiefly a “bankers’ bank.” It acts like a central bank, with functions similar to those of a branch of the Federal Reserve. It avoids rivalry with private banks by partnering with them. Most lending is originated by a local bank. The BND then comes in to participate in the loan, share risk and buy down the interest rate.

One of the BND's functions is to provide a secondary market for real estate loans, which it buys from local banks. Its residential loan portfolio is now $500 billion to $600 billion. This function has helped the state to avoid the credit crisis that afflicted Wall Street when the secondary market for loans collapsed in late 2007. Before that, investors routinely bought securitized loans (CDOs) from the banks, making room on the banks' books for more loans. But these "shadow lenders" disappeared when they realized that the derivatives called "credit default swaps" supposedly protecting their CDOs were a highly unreliable form of insurance. In North Dakota, this secondary real estate market is provided by the BND, which has invested conservatively, avoiding the speculative derivatives debacle.

Other services the BND provides include guarantees for entrepreneurial startups and student loans, the purchase of municipal bonds from public institutions and a well-funded disaster loan program. When the city of Fargo was struck by a massive flood recently, the disaster fund helped the city avoid the devastation suffered by New Orleans in similar circumstances; and when North Dakota failed to meet its state budget a few years ago, the BND met the shortfall. The BND has an account with the Federal Reserve Bank, but its deposits are not insured by the FDIC. Rather, they are guaranteed by the State of North Dakota itself – a prudent move today, when the FDIC is verging on bankruptcy.

The Commercial Banking Model: The Commonwealth Bank of Australia

The BND studiously avoids competition with private banks, but a publicly-owned bank could profitably engage in commercial lending. A successful model for that approach was the Commonwealth Bank of Australia, which served both central bank and commercial bank functions. For nearly a century, the publicly-owned Commonwealth Bank provided financing for housing, small business, and other enterprise, affording effective public competition that "kept the banks honest" and kept interest rates low. Commonwealth Bank put the needs of borrowers ahead of profits, ensuring that sound investment flows were maintained to farming and other essential areas; yet, the bank was always profitable, from 1911 until nearly the end of the century.

Indeed, it seems to have been too profitable, making it a takeover target. It was simply "too good not to be privatized." The bank was sold in the 1990s for a good deal of money, but it's proponents consider it's loss as a social and economic institution to be incalculable.

A State Bank of Florida?

Could the sort of commercial model tested by Commonwealth Bank work today in the United States? Economist Farid Khavari thinks so. A Democratic candidate for governor of Florida, he proposes a Bank of the State of Florida (BSF) that would make loans to Floridians at much lower interest rates than they are getting now, using the magic of fractional reserve lending. He explains:

"For $100 in deposits, a bank can create $900 in new money by making loans. So, the BSF can pay 6 percent for CDs, and make mortgage loans at 2 percent. For $6 per year in interest paid out, the BSF can earn $18 by lending $900 at 2 percent for mortgages."

The state would earn $15,000 per $100,000 of mortgage, at a cost of about $1,700, while the homeowner would save $88,000 in interest and pay for the home 15 years sooner. "Our bank will save people about seven years of their pay over the course of 30 years, just on interest costs," says Dr. Khavari. He also proposes 6 percent credit cards and 6 percent certificates of deposit.

The state could earn billions yearly on these loans, while saving hefty sums for consumers. It could also refinance its own debts and those of its municipal governments at very low interest rates. According to a German study, interest composes 30 percent to 50 percent of everything we buy. Slashing interest costs can make projects such as low-cost housing, alternative energy development, and infrastructure construction not only sustainable, but profitable for the state, while at the same time creating much-needed jobs.

Written for Truthout.

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: Non-toxic Dentistry (co-authored with Dr. Richard Hansen). Her websites are www.webofdebt.com and www.ellenbrown.com.

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