The Global Debt Crisis: How We Got In It, and How to Get Out

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Global Research, June 06, 2011
Web of Debt 6 June 2011

Region: USA
Theme: Global Economy

Countries everywhere are facing debt crises today, precipitated by the credit collapse of 2008. Public services are being slashed and public assets are being sold off, in a futile attempt to balance budgets that can't be balanced because the money supply itself has shrunk. Governments usually get the blame for excessive spending, but governments did not initiate the crisis. The collapse was in the banking system, and in the credit that it is responsible for creating and sustaining.

Contrary to popular belief, most of our money today is not created by governments. It is created by private banks as loans. The private system of money creation has grown so powerful over the centuries that it has come to dominate governments globally. The system, however, contains the seeds of its own destruction. The source of its power is also a fatal design flaw.

The flaw is that banks advance "bank credit" that must be paid back with interest, while having no obligation to spend the interest they collect so that borrowers can earn it again and again, as they must in order to retire the debt. Instead, this money is invested in various casinos beyond the borrowers' reach. This leads to a continual systemic need for more new bank credit money, more debt with more interest attached, to prevent widespread defaults and deflationary collapse.

Today this problem is particularly evident in the EU. The Euro is a fixed currency system that does not allow for expansion to meet the demands of the private lending casino. The result is that EU member nations collectively are being crippled by debt.

There are more sustainable ways to run a banking and credit system, as will be shown.

How Banks Create Money

The process by which banks create money was explained by the Chicago Federal Reserve in a booklet called "Modern Money Mechanics." It states:

"The actual process of money creation takes place primarily in banks." [p3]

"[Banks] do not really pay out loans from the money they receive as deposits. If they did this, no additional money would be created. *What they do when they make loans is to accept promissory notes in exchange for credits to the borrowers' transaction accounts*. Loans (assets) and deposits (liabilities) both rise [by the same amount]." [p6]

"With a uniform 10 percent reserve requirement, a $1 increase in reserves would support $10 of additional transaction accounts." [p49]

A $100 deposit supports a $90 loan, which becomes a $90 deposit in another bank, which supports an $81 loan, etc.

That's the conventional model, but banks actually create the loans FIRST. (Picture how a credit card works.) Banks need deposits to clear their outgoing checks, but they find the deposits later. Banks create money as loans, which become checks, which go into other banks. Then, if needed to clear the checks, they borrow the money back from the other banks. In effect, they borrow back the money they just created, pocketing the spread between the interest rates as their profit. The rate at which banks can borrow from each other in the U.S. today (the Fed funds rate) is an extremely low 0.2%.

How the System Evolved

The current system of privately-issued money is traced in "Modern Money Mechanics" to the 17th century goldsmiths. People who left gold with the goldsmiths for safekeeping would be issued paper receipts for it called "banknotes." Other people who wanted to borrow money were also happy to accept paper banknotes in place of gold, since the notes were safer and more convenient to carry around. The sleight of hand came in when the goldsmiths discovered that people would come for their gold only about 10% of the time. That meant that up to ten times as many notes could be printed and lent as the goldsmiths had gold. Ninety percent of the notes were basically counterfeited.

This system was called "fractional reserve" banking and was institutionalized when the Bank of England was founded in 1694. The bank was allowed to lend its own banknotes to the government, forming the national money supply. Only the interest on the loans had to be paid. The debt was rolled over indefinitely.

That is still true today. The U.S. federal debt is never paid off but just continues to grow, forming the basis of the U.S. money supply.

The Public Banking Alternative

There are other ways to create a banking system, ways that would eliminate its ponzi-scheme elements and make the system sustainable. One solution is to make the loans interest-free; but for Western economies today, that transition could be difficult.

Another alternative is for banks to be publicly-owned. If the people collectively own the bank, the interest and profits go back to the government and the people, who benefit from decreased taxes, increased public services, and cheaper public infrastructure. Cutting out interest has been shown to reduce the cost of public projects by 30-50%.

In the United States, this system of publicly-owned banks goes back to the American colonists. The best of the colonial models was in Benjamin Franklin's colony of Pennsylvania, where the government operated a "land bank." Money was printed and *lent* into the community. It recycled back to the government and could be lent and relent. The system was mathematically sound because the interest and profits were returned to the government, which then *spent* the money back into the economy in place of taxes. Private banks, by contrast, generally *lend* their profits back into the economy, or invest in private money-making ventures in which more is always expected back than was originally invested.

During the period that the Pennsylvania system was in place, the colonists paid no taxes except excise taxes, prices did not inflate, and there was no government debt.

How Private Banknotes Became the National U.S. Currency

The Pennsylvania system was sustainable, but some early American colonial governments just printed and spent, inflating the money supply and devaluing the currency. The British merchants complained, prompting King George II to forbid the colonists to issue their own money. Taxes had to be paid to England in gold. That meant going into debt to the English bankers. The result was a massive depression. The colonists finally rebelled and went back to issuing their own money, precipitating the American Revolution.

In an international first, the colonists funded a war against a major power with mere paper receipts, and won. But the British counterattacked by waging a currency war. They massively counterfeited the colonists' paper money, at a time when this was easy to do. By the end of the war, the paper scrip was virtually worthless. After it lost its value, the colonists were so disillusioned with paper money that they left the power to issue it out of the U.S. Constitution.

Meanwhile, Alexander Hamilton, the first U.S. Treasury Secretary, was faced with huge war debts, and he had no money to pay them. He therefore resorted to the ruse used in England known as fractional reserve banking. In 1791, Hamilton set up the First U.S. Bank, a largely private bank that would print banknotes "backed" by gold and lend them to the government.

The ruse worked: the paper banknotes expanded the money supply, the debts were paid, and the economy thrived. But it was the beginning of a system of government funded by debt to private bankers, who lent banknotes only nominally backed by gold.

During the American Civil War, President Lincoln avoided a crippling war debt by returning to the system of government-issued money of the American colonists. He issued U.S. Notes from the Treasury called "Greenbacks" rather than borrowing at usurious interest rates. But Lincoln was assassinated, and Greenback issuance was halted.

In 1913, the privately-owned Federal Reserve was authorized to issue its own Federal Reserve Notes as the national currency. These notes were then lent to the government, eliminating the government's own power to issue money (except for coins). The Federal Reserve was set up to prevent bank runs, but twenty years later we had the Great Depression, the greatest bank run in history. Robert H. Hemphill, Credit Manager of the Federal Reserve Bank of Atlanta, wrote in 1934:

"We are completely dependent on the commercial Banks. *Someone has to borrow every dollar we have in circulation, cash or credit*. If the Banks create ample synthetic money we are prosperous; if not, we starve."

For the bankers, however, it was a good system. It put them in control.

Setting the Global Debt Trap

Prof. Carroll Quigley was an insider groomed by the international bankers. He wrote in Tragedy and Hope in 1966:

"The powers of financial capitalism had another far reaching aim, nothing less than to create a world system of financial control in private hands able to dominate the political system of each country and the economy of the world as a whole.

"The apex of the system was to be the Bank for International Settlements [BIS] in Basle, Switzerland, a private bank owned and controlled by the world's central banks which were themselves private corporations. Each central bank… sought to dominate its government by its ability to control Treasury loans…."

The debt trap was set in stages. In 1971, the dollar went off the gold standard internationally. Currencies were unpegged from gold and allowed to "float" in currency markets, competing with other currencies, making them vulnerable to speculation and manipulation.

In 1973, a secret agreement was entered into in which the OPEC countries would sell oil only in dollars, and the price of oil would be dramatically increased. By 1974, oil prices had increased by 400% from 1971 levels. Countries lacking oil had to borrow dollars from U.S. banks.

In 1981, the Fed funds rate was raised to 20%. At 20% compound interest, debt doubles in under four years. As a result, most of the world became crippled by debt. By 2001, developing nations had repaid the principal originally owed on their debts six times over; but their total debt had quadrupled because of interest payments.

When debtor nations could not pay the banks, the International Monetary Fund stepped in with loans — with strings attached. The debtors had to agree to "austerity measures," including:

- cutting social services
- privatizing banks and public utilities
- opening markets to foreign investors
- letting currencies "float."

Today, austerity measures are being imposed not just in developing countries but in the European Union and on U.S. States.

The BIS: Apex of the Private Central Banking Pyramid

What Professor Quigley foretold about the Bank for International Settlements (BIS) has also come to pass. The BIS now has 55 member nations and heads the global financial pyramid.

The power of the BIS was seen in 1988, when it raised the capital requirement of its member banks from 6% to 8% in an accord called Basel I. The result was to cripple the Japanese banks, which until then were the world's largest creditors. Japan entered a recession from which it has not yet recovered.

U.S. banks managed to escape by dodging the capital requirement. They did this by moving loans off their books, bundling them up as "securities," and selling them to investors.

To persuade the investors to buy them, these mortgage-backed securities were protected against default with "derivatives," which were basically just bets. The "protection seller" collected a premium for agreeing to pay in the event of default. The "protection buyer" bought the premium. Owning the asset was not required. Like gamblers at a horse race, derivative players could bet without owning a horse.

Derivatives became a very popular form of gambling. The result was the mother of all bubbles, exceeding $500 trillion by the end of 2007.

Because of securitization and derivatives, credit mushroomed. Virtually anyone who walked in the door could get a loan.

The tipping point came in August 2007, with the collapse of two hedge funds. When the derivatives scheme was exposed, the market for derivative-protected securities suddenly dried up. But the U.S. stock market did not collapse until November 2007, when new accounting rules were imposed. The rules grew out of the Basel II Accords initiated by the BIS in 2004. "Mark to market" accounting required banks to value their assets according to market demand that day. Many U.S. banks, like those in Japan in the 1990s, suddenly had insufficient capital to make new loans. The result was a credit crisis from which the U.S. has not yet recovered.

The BIS has now become global regulator, just as Quigley foresaw. In April 2009, the G20 nations agreed to be regulated by a Financial Stability Board based in the BIS, and to comply with "standards and codes" set by the Board. The codes are only guidelines, but countries that fail to comply risk downgrades in their credit ratings, something so costly that the guidelines have effectively become laws.

An article on the BIS website states that central banks in the Central Bank Governance Network should have as their single or primary objective "to preserve price stability." That means governments should not devalue the national currency by inflating the money supply; and that means not "printing money" or borrowing credit created by their own central banks. Like the American colonies after King George took away their power to issue their own money, governments must fund their deficits by borrowing from private banks. The bankers' global control over currency issuance has become virtually complete.

The effects of this policy are particularly evident in the European Union, where EU rules allow deficits of only 3% of government budgets and prevent member countries from either issuing their own money or borrowing credit advanced by their own central banks. Member nations must borrow instead from the European Central Bank, private international banks, or the IMF. The result has been forced austerity measures, as seen in Greece and Ireland. The system is so unsustainable that commentators are predicting that the EU may break up.

The Way Out: Return the Money Power to Public Control

To escape the debt trap of the global bankers, the power to create the national money supply needs to be restored to national governments. Alternatives include:

· Legal tender issued directly by national treasuries and spent on national budgets.

· Publicly-owned central banks empowered to advance the nation's credit and lend it to the government interest-free.

· Nationalization of bankrupt banks considered "too big to fail" (after expunging or writing down bad debts on inflated bubble assets). These banks could then issue credit to the public and serve the public's banking needs, with the profits recycling back to the government, defraying the tax burden on the people.

· Publicly-owned local banks (state, provincial, or municipal).

Publicly-owned banks have been successfully established and operated in many countries, including Australia, New Zealand, Canada, Germany, Switzerland, India, China, Japan, Korea, and Malaysia.

In the United States there is currently only one state-owned bank, the Bank of North Dakota. The model, however, has proven to be highly successful. North Dakota is the only U.S. state to have escaped the credit crisis unscathed. In 2009, while other states floundered, North Dakota had its largest budget surplus ever. In 2008, the Bank of North Dakota (BND) had a return on equity of 25%. North Dakota has the lowest unemployment rate in the country and the lowest default rate on loans. It also has the most local banks per capita.

North Dakota has had its own bank since 1919, when farmers were losing their farms to the Wall Street bankers. They organized, won an election, and passed legislation. The state is required by law to deposit all its revenues in the BND. Like with the sustainable model of the bank of colonial Pennsylvania, interest and profits are returned to the government and to the local economy.

A growing movement is afoot in the United States to copy this public banking model in other states. Fourteen U.S. state legislatures have now initiated bills for state-owned banks.

The model could also be replicated in other countries. In Ireland, for example, where the major banks are insolvent and are already nationalized or soon will be, the government could deposit its revenues in its own publicly-owned banks, add sufficient capital to meet capital requirements, and leverage these funds to create interest-free credit for its own local needs. That is exactly what Alexander Hamilton did when faced with government debts that were impossible to repay: he put the government's existing funds in a bank, then borrowed the money back several times over, employing the accepted "fractional reserve" model.

Japan's solution is also a variant of what Alexander Hamilton proposed two centuries earlier. Japan retains its status as the third largest economy in the world although it has a debt to GDP ratio of 226%. Japan has "monetized" the national debt, turning it into the national money supply. The government-owned Bank of Japan holds Japanese government debt equal to 100% of the nation's GDP; and because the government owns the bank, this loan is interest-free and can be rolled over indefinitely. An interest-free loan rolled over indefinitely is the equivalent of issuing money.

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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