VII. EFFECT OF 100% CHARTERED BANK CASH RATIOS

(a) Comment on the 100% Reserve Proposal

(Submitted by Mr. Towers in reply to Mr. Tucker)

(Volume 3, page 90)

The major point raised by Mr. Tucker on February 16th in the House of Commons was, in effect, that the central bank should advance Bank of Canada notes to the Government free of charge, and that the Government should use this money to repay maturing obligations, or perhaps to finance its current expenditures.

For whatever purpose the Government used these notes, and no matter to whom it paid them, the result would be to increase the cash reserves of the commercial banks. The initial effect of the transaction upon the banks is the same as if they had been forced to invest in non-interest-bearing Government securities. Subsequent effects depend upon the use which the banks make of their increased cash reserves.

If the increase in cash reserves persuaded the banks to make loans or investments which on the basis of their former high cash ratio they had considered undesirable or which would cause inflation, it would become the duty of the Bank of Canada to prevent such credit expansion. This might be accomplished by reducing cash reserves to their former level, or by increasing the legal minimum ratio of such reserves to deposits.

If the Bank of Canada were to reduce the amount of cash reserves by selling Government securities, the effect would be to put both the banks and the Government in the same position as if the Government had originally sold securities to the public instead of taking notes from the Bank of Canada. Although the Government in the latter case would not have increased its interest-bearing debt it would be paying interest on issues formerly held by the Government-owned central bank which transfers the large part of its net profits to the Government.

If the situation were dealt with by raising the banks' legal minimum cash ratio, instead of reducing cash reserves, the effect would be the same as if the banks had voluntarily refrained from credit expansion on the basis of the increase in cash reserves. Since a large part of the increase in bank deposits occasioned by the return of the additional Bank of Canada notes to the banks would be in interest-bearing deposits, without any increase in banks' earning assets, the result would be to reduce banks' net earnings.

It is important to remember that financial institutions, of which banks are one example, hold securities and have earnings for the benefit of their creditors, who, in the case of banks, are depositors. Any action such as the policy under discussion, which reduces the earnings of these institutions, acts to the detriment of their creditors and becomes a form of discriminatory taxation without regard for ability to pay. As an illustration of the course which these adjustments take, lower banks' earnings in recent years, due to smaller security yields and the decline in the volume of loans, have been offset to a large extent by a 50 per cent cut in the rate of interest paid on savings deposits.

A later suggestion was to the effect that the cash reserve requirements should be gradually increased until every cent owing by the banks to their depositors, was covered by legal tender. What I said earlier in respect to the proposal to increase minimum reserve requirements applies to this suggestion, but naturally with greater force. It is a proposal which, broadly speaking, involves two things:

(a) Taxation of bank depositors, and
(b) The setting up of some new form of banking system to make loans.